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Title of Dissertation: Repealing the Glass-Steagall Framework: Deregulatory Impact and Policy Considerations in Historical Context

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ABSTRACT

Title of Document: REPEALING THE GLASS-STEAGALL FRAMEWORK: DEREGULATORY IMPACT AND POLICY CONSIDERATIONS IN HISTORICAL CONTEXT

Timothy J. Galpin, Ph.D., 2019

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Repealing the Glass-Steagall Framework is a policy history of financial modernization as seen through the formulation and passage of the Gramm Leach Bliley Act of 1999 and the Commodity Futures Modernization Act of 2000. Based on extensive historical research, this work reconstructs the evolving institutional, economic, and policy context leading up to the 106th Congress to explain why the Gramm Leach Bliley Act and Commodity Futures Modernization Act had significantly less deregulatory impact on the U.S. financial system than some critics claimed after the financial crisis of 2008. This broadly based analysis examines the constraints imposed by dynamic market conditions, the incremental repeal of untenable New Deal laws and regulations, as well as divergent corporate interests among large commercial bankers, securities broker-dealers, and insurers. It also considers the views of leading regulators and key congressional committee chairmen who misunderstood the systemic risk posed by increasingly complex and interrelated financial markets and relied on the evolving neoliberal ideological consensus to support their preferences for self-regulation and their efforts to restore U.S. global competitiveness. As a result, this research makes clear that the approach taken to financial modernization by the 106th Congress represented a historic missed opportunity to ensure the safety and soundness of the U.S. financial system by imposing regulations

that properly accommodated new financial institutions, products, and markets such as over-the-counter derivatives. This dissertation represents groundbreaking research in public policy at the intersection of American Political Development and History of Capitalism.

REPEALING THE GLASS-STEAGALL FRAMEWORK: DEREGULATORY IMPACT AND POLICY CONSIDERATIONS IN HISTORICAL CONTEXT

By

Timothy J. Galpin

Dissertation submitted to the Faculty of the Graduate School of the
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Dedication

To Vicki for her love and encouragement

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List of Abbreviations

ABA	American Bankers Association
ABASA	ABA Securities Association
ABAIA	ABA Insurance Association
ACB	America's Community Bankers
ACLI	American Council of Life Insurance
AIA	American Insurance Association
APD	American Political Development
BHCA	Bank Holding Company Act of 1956
CDS	Credit default swap
CEA	Commodity Exchange Act of 1936
CEBA	Competitive Equality Banking Act of 1987
CFHLB	Council of Federal Home Loan Banks
CFMA	Commodity Futures Modernization Act
CIAB	Council of Insurance Agents and Brokers
CFTC	Commodity Futures Trade Commission
CMA	Cash Management Account
CRA	Community Reinvestment Act
CSBS	Conference of State Bank Supervisors
CUMAA	Credit Union Membership Access Act of 1998
DIDMCA	Depository Institutions Deregulation and Monetary Control Act of 1980
DPG	Derivatives Policy Group
FASB	Federal Accounting Standards Board
FCRA	Fair Credit Reporting Act
FDIC	Federal Deposit Insurance Corporation
FDICIA	Federal Deposit Insurance Corporation Improvement Act of 1991
FFIEC	Federal Financial Institutions Examination Council
FHLBB	Federal Home Loan Bank Board
FIRREA	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FRS	Federal Reserve System
FSCC	Financial Services Coordinating Council
FSLIC	Federal Savings and Loan Insurance Corporation
GAAP	Generally Accepted Accounting Principles
GAO	U.S. Government Accountability Office (General Accounting Office)
GLBA	Gramm Leach Bliley Act of 1999
GSA	Glass-Steagall Act of 1933
GSG	Garn-St. Germain Depository Institution Act of 1982
IBAA	Independent Bankers Association of America
ICBA	Independent Community Bankers of America
ICI	Investment Company Institute
IIAA	Independent Insurance Agents of America
LMI	Low-to-moderate income communities
LTCM	Long-Term Capital Management
MBS	Mortgage-backed security
MMF	Money market mutual fund

NAIC	National Association of Insurance Commissioners
NAII	National Association of Independent Insurers
NARAB	National Association of Registered Agents and Brokers
NASD	National Association of Securities Dealers
NBA	National Bank Act of 1916
NGA	National Governors Association
NOW	Negotiable Order of Withdrawal
OCC	Office of the Comptroller of the Currency
OTC	Over-the-counter
OTS	Office of Thrift Supervision
RBC	Regional Bank Compact
RN	Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994
SLHCA	Savings and Loan Holding Company Act of 1967
SEC	Securities and Exchange Commission
SIA	Securities Industry Association
SRO	Self-regulatory organization
UTHC	Unitary thrift holding company
WFI	Wholesale financial institutions

Introduction

According to traditional literature on finance, beginning in 1979, banking regulation in the United States underwent a transformation as broad and sweeping as the series of laws and regulations that created the New Deal banking regulatory structure during the Great Depression. The last major step to be taken in dismantling the New Deal regulatory approach to banking was elimination of the requirement to keep commercial banking, investment banking, and insurance separate. That goal was accomplished by the Financial Service Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act (GLBA), which overturned the relevant portions of the Glass-Steagall Act of 1933. GLBA was an important law that completed an evolutionary trend in the repeal of Depression-era banking laws.[1]

However, in meaningful ways, the deregulatory aspects of GLBA were not as transformative as is often portrayed in the scholarly literature. To obtain the political compromises necessary to pass GLBA, supporters had to ensure that the legislation largely preserved and reinforced the financial system's underlying regulatory structure. Furthermore, when GLBA is considered in conjunction with the related Commodity Futures Modernization Act (CFMA), it is clear that Congress deliberately omitted opportunities for innovative regulatory reforms that would accommodate the oversight of new financial markets, institutions, and products such as the market for over-the-counter (OTC) derivatives. It was this failure rather than the nominally deregulatory nature of

[1] Charles W. Calomiris and Eugene N. White, "The Origins of Federal Deposit Insurance," in *U.S. Bank Deregulation in Historical Perspective*, ed. Charles W. Calomiris (New York: Cambridge University Press, 2006), 164-211. The other remaining vestige of New Deal Banking laws was federal deposit insurance, which was not under consideration for repeal.

financial services modernization that placed at risk the safety and soundness of the financial system going forward.

The Financial Services Industries

The Gramm Leach Bliley Act was also known officially as The Financial Services Modernization Act of 1999. The financial services industries affected by the act were commercial banking, investment banking, and insurance. Commodity and related futures trading were notably excluded from the legislation, as were other financial services such as hedge funds and derivatives. The term “financial services modernization” was something of a misnomer as the legislation was focused on the repeal of Glass-Steagall, and the compromises necessary to achieve that goal, rather than a broader reform of the financial system. This section provides a brief description of the financial services industries as background.

U.S. Banking: A Variety of Institutions

The banking system is an integral part of the U.S. economy. As a capitalist society, the U.S. depends on a well-funded, safe and secure banking system. Banks pool and absorb risks for depositors, provide a stable source of investment and working capital, and facilitate financial and other resources flowing to their highest return uses.

In the United States, the term “bank” typically describes one of two categories of financial institutions. The first major type is a depository institution that receives deposits and makes loans. These institutions are known as commercial banks, sometimes called retail banks if focused on individual customers and small businesses. Common functions at commercial banks include checking services, savings accounts, consumer and business loans, which include mortgages, and short-term investments such as certificates of deposit. Although financial developments and information technologies have provided alternative funding sources for large commercial enterprises, commercial banks remain the single most important source of funds for small business borrowers, which lack the resources of larger established companies.[2]

Other types of depository institutions in the U.S. include credit unions and thrifts, which evolved historically to pool funds in a local community to create a loan pool for members. The term "thrifts" encompasses savings and loans associations as well as mutual savings banks, which primarily serve small savers. Thrifts are owned by members and specialize in home mortgages. A credit union is a member-owned cooperative that pools funds to offer loans and mortgages to its members. Specific limitations are imposed on commercial banks, thrifts, and credit unions by their charters, whether national or state, and their respective regulatory oversight agencies.[3]

Commercial Banking

Commercial banks were subject to government regulation as an implicit quid pro quo for federal deposit insurance, which was created in 1933-1934. The objective of federal deposit insurance was not only to keep the public's deposits safe but also to maintain public confidence and avoid bank runs. The fear of moral hazard, or that banks with government insurance would take greater investment risks, convinced policymakers that commercial banking required relatively strong government supervision. Bank examiners sought to identify and resolve problems in advance in order to prevent

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[2] Allen N. Berger, et al., "The Transformation of the U.S. Banking Industry: What a Long, Strange Trip It's Been," *Brookings Papers on Economic Activity 1995*, no. 2 (1995): 55-56.

[3] Although deregulation in the 1980s and early 1990s eventually allowed thrifts and credit unions to offer many of the services historically reserved for retail banks, they continued to specialize in mortgage and small retail loans.

insolvencies and demands on the federal deposit insurance funds. Additionally, as will be discussed later, regulators subjected commercial banks to interest rate limitations and enjoined them from riskier investments in securities or insurance underwriting.

The U.S. commercial banking system evolved to include two unique features. One was a dual system of federal and state banking charters. The distinct dual structure of the U.S. banking system reflected the historical influence of federalism, and in particular the way in which Congress and courts declined to apply the commerce clause to banking. These policy decisions allowed states to define their own banking systems, which they did in part to protect themselves from the perceived exploitations of the New York bankers and Eastern money elites.[4]

The federal-state charter system evolved through several major banking upheavals, including the establishment of the Office of the Comptroller of the Currency in 1864, the Federal Reserve System in 1913, and the restrictions imposed by the Banking Act of 1933. Unfortunately, this led to a complicated and overlapping regulatory structure. For example, national banks were chartered and regulated by the Office of the Comptroller of the Currency and state-chartered banks were primarily regulated by the relevant state banking authority. However, even state-chartered banks required significant federal regulation. For instance, the Board of Governors of the Federal Reserve (FRB) provided federal oversight of state banks that joined the federal reserve system (e.g., for access to the federal payment system). Similarly, the Federal Deposit Insurance Corporation (FDIC) was the primary federal regulator for state banks with access to

[4] Sven Beckert, *The Monied Metropolis: New York City and the Consolidation of the American Bourgeoisie, 1850-1896* (New York: Cambridge University Press, 2001), 2-3.

federal deposit insurance that did not choose to join the Federal Reserve System. Additionally, the Bank Holding Company Act of 1956 made the nonbanking activities of state or national banks owned by a holding company subject to FRB regulation.[5]

The other unique historical feature of U.S. banking was a system of geographic restrictions on bank branching and interstate banking, which were designed to ensure local deposits would be available to reinvest in local businesses and agriculture. Unfortunately, these protected markets could and did lead to inefficiencies in allocating capital and prevented both national and state banks from achieving economies of scale. However, the strong bias among U.S. policymakers against large banks and towards protecting local depositors and agrarian interests remained until geographic restrictions were finally removed in 1994.[6]

Investment Banking and Securities Brokerage

The second major type of bank is typically referred to as an investment bank. These institutions focus on underwriting securities, proprietary trading on the bank's own accounts, and providing research as well as corporate merger and acquisition advice to other businesses. The investment banks that specialized in underwriting and marketing securities were sometimes known simply as broker-dealers.

In the context of investment banking, securities are a class of investments that comprise two fundamental methods of raising funds for institutions, whether private or public. Equities, or stocks, are issued by private enterprises, which are called "public

[5] Kenneth Spong, *Banking Regulation: Its Purposes, Implementation, and Effects*, (Kansas City: Federal Reserve Bank of Kansas City, 2000), 18-21.

[6] Lissa L. Broome and Jerry W. Markham, *Regulation of Bank Financial Service Activities: Cases and Materials* (St. Paul, MN: Thomson/West, 2008), 59-60; Calomiris and White, "Federal Deposit Insurance," 166-169.

companies" when their shares are listed on publicly traded exchanges. Bonds are issued variously by the federal government, state and local governments, private enterprises, and other infrastructure revenue authorities. Although the federal government runs its own bond auctions, generally corporate equities as well as both corporate and government bonds are underwritten, or issued, via investment banks. These equities and bonds trade on their own public markets via registered brokers or dealers, and both the markets and broker-dealers are regulated in order to ensure no unfair advantages accrue to insiders. However, not all securities trade publicly, and U.S. privately traded securities and markets are restricted to accredited buyers who trade at their own risk.

Unlike commercial banking, which receives proactive supervision by bank examiners, the securities industry is regulated by the Securities and Exchange Commission (SEC), which focuses more on markets than on protecting institutions. The securities markets are understood to be riskier, and subject to market discipline. That is, investment banks and investors are expected to have sufficient knowledge to exercise due diligence to protect themselves. Self-regulatory organizations (SROs) such as stock exchanges or the National Association of Securities Dealers (NASD) also have a regulatory role for securities markets. This role was grounded in the industry expertise the institutions provided and minimized the federal government's regulatory footprint. Over time it became common for the SROs to provide oversight of broker-dealers, stock exchange members and listed firms, futures traders, and others in conjunction with the

SEC.[7] Government action, if it was necessary, came in the form of public enforcement actions to discipline the offending institution.[8]

This private-public approach to securities included the expectation of self-interest on the part of the regulated entities. Unlike in commercial banking, where moral hazard existed, the public policy purpose of market regulation for securities could be met without direct government regulatory control and oversight and had the additional advantage of shifting the financial burden of regulation to the SRO. In return, on behalf of the securities industry, the various SROs gained the "flexibility to adapt quickly to market change, create more relevant regulations for its members, and maintain the authority to self-police its members."[9]

Insurance

By way of background, insurance is a contract, or policy, that provides financial coverage to the insured for future losses or expected payouts. In America, it was originally oriented towards protecting owners from shipping losses, although it quickly grew to include protections for loss from fire in large urban centers, and ultimately

[7] CFA Institute, "Self-Regulation in Today's Securities Markets: Outdated System or Work in Progress?" (2007): iii. NASD was founded in 1939 by member broker-dealers. It merged with the New York Stock Exchange regulation committee to form the Financial Industry Regulatory Authority (FINRA) in 2007.

[8] U.S. Government Accounting Office, "Risk-Based Capital: Regulatory and Industry Approaches to Capital and Risk," Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, and the Chairman, Committee on Banking and Financial Services, House of Representatives (July 20, 1998): 9; "Final Rule: S7-13-98," accessed November 28, 2017, https://www.sec.gov/rules/final/34-40761.htm; CFA Institute, "Self-Regulation in Today's Securities Markets,"1-3.

[9] Arthur Levitt, "Letter to Senator Gramm on SEC Oversight of FASB," Columbia University Rare Books and Manuscript Library (May 2, 2000): 2; Jonathan Barron Baskin and Paul J. Miranti, *A History of Corporate Finance* (New York: Cambridge University Press, 1997), 200-203; CFA Institute, "Self-Regulation in Today's Securities Markets," 4-10.

covered a myriad of potential losses. Insurance works by aggregating the risks of the insured in order to reduce costs to the individual members of the pool. The many types of insurance led to conflicts with the other financial services industries. For example, consider the case of mortgage insurance, which banks as originators and holders of mortgages not unreasonably claimed to be a banking product. The resolution of such disputes became a matter for the courts, and ultimately put insurers at a disadvantage when the Supreme Court sided with federal agencies such as the Office of the Comptroller of the Currency or the Federal Reserve to allow banks to sell insurance products in some circumstances.[10]

While banking regulation has a mix of federal and state regulation, insurance remains primarily regulated by the states. Attempts to provide federal oversight of insurance in the mid-19th century all failed. Unlike the banking system no dual-chartered federal system was ever created for insurance. This was primarily because *Paul v. Virginia* (1868) and other early judicial precedents made clear that insurance was not interstate commerce, so it was subject to business regulation by the states but not federal regulation. Insurance companies initially chafed under the burden of differing regulations across multiple venues, especially when states such as New York, with its large financial services industry, began to establish and enforce stringent rules. Although insurance companies initially attempted to head off this patchwork of state level regulation, they

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[10] Lissa L. Broome and Jerry W. Markham, "Banking and Insurance: Before and After the Gramm-Leach-Bliley Act," *Journal of Corporation Law* 25, no. 4 (2000): 723-64. There are additional dimensions of complexity in the business of insurance. Many insurance companies are mutualized, with the policy members owning the company, while others are publicly traded. Additionally, there are many types of insurance. Both individuals and businesses make use of property and casualty insurance. Typical examples of insurance types for individuals include home, automobile, health, and life. Businesses and some individuals also use various forms of liability insurance.

became convinced by aggressive federal actions in banking that state regulation was preferable to federal.[11]

At the turn of the 20th century, insurance companies began to accumulate significant wealth and occasionally abuse the power that wealth generated for them, including stock market manipulations. Louis Brandeis and others suggested that these abuses warranted reconsideration of federal oversight. In response, the states led industry reform. In one famous case, the New York Superintendent of Insurance convinced the state legislature to empower a commission headed by Senator William W. Armstrong to investigate the excesses of James Hyde, who owned the Equitable Life Assurance Company. The subsequent investigation by the Armstrong Commission made recommendations that convinced state policymakers to establish and enforce more stringent restrictions on the investment activities of insurance companies.[12]

These state reforms had the effect of insulating the insurance companies from the worst of stock market excesses that preceded the 1929 Crash. For example, in New York and other states, after 1906 insurance companies were restricted from investing in equities and prohibited from underwriting securities. Instead of equities, insurance companies invested in federal, state, local and private bonds as well as real estate. As a result, although insurance companies suffered significant losses during the Depression,

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[11] *Paul v. Virginia*, 75 U.S. 168 (1868); *Fire Ass'n of Phila. v. New York*, 119 U.S. 110, 119-20 (1886); Broome and Markham, "Before and After," 723-64.

[12] William W. Armstrong, "Testimony Taken before the Joint Committee of the Senate and Assembly of the State of New York to Investigate and Examine into the Business and Affairs of Life Insurance Companies Doing Business in the State of New York," Vol. I-X, 1905, held in the Cornell University Library Archive.

Congress did not seek to regulate the insurance industry as it had the banking and securities industries.[13]

~~S~~tate oversight of the insurance industry eventually became a norm that even Congress was willing to defend. In *South-Eastern Underwriters* (1944), a case revolving around price fixing, the Supreme Court held that insurance companies were subject to federal antitrust laws.[14] In response, the insurance industry petitioned Congress for help. This resulted in the McCarran-Ferguson Act, which exempted insurance companies from federal antitrust law to the extent that they were effectively regulated by state law. Of course, McCarran-Ferguson was not the last word, and the insurance industry and state commissioners continued to battle with federal regulators, notable the FTC, which drove the insurance industry's attitudes towards federal regulation.[15]

In the absence of federal regulation, the insurance industry turned to its own trade associations. For example, the National Association of Insurance Commissioners (NAIC), a trade association, served a coordination role among the states in the place of a federal regulator. In addition to governing the state insurance examinations process, the NAIC often coordinated among other insurance trade associations to draft model laws (e.g., the model insurance holding company act). Even though it had no compulsory or enforcement power, the NAIC was in fact acting in concert with the industry's best

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[13] Broome and Markham, "Before and After," 723-64. During the Great Depression insurance companies suffered large loss of their capital reserves and returns continued to suffer as they shifted into low interest rate instruments such as government bonds. For example, approximately 130 insurance companies borrowed over $90 million from the Reconstruction Finance Corporation (RFC). As policy holders sought to cash in insurance policies for surrender values during the Depression, many states passed laws to freeze surrender claims.

[14] *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944).

[15] 15 U. S. C. § 1012(b); Thomas Lee Hazen, *Treatise on the Law of Securities Regulation,* 2nd Edition (New York: West Group, 1990), 6-8.

interests by providing uniformity to facilitate business practices and standards to keep bad actors out of the industry.[16]

The salient fact is that by the late 20th century the insurance industry was comfortable with its state-run regulatory structure and had little to no interest in federal regulation of insurance. As a result, state regulation remained the norm for the insurance industry during the financial modernization debates of the late 1990s. This became a driving factor in the political compromises that shaped GLBA as banks moved to expand their businesses into insurance and the insurance companies sought to hold them off. During the financial services modernization debate the issue of federal regulation of insurance was driven by several factors other than industry financial performance, including bank insurance activities, insurance banking activities, and the arrival of new hybrid products that had sufficient aspects of securities to warrant oversight by the SEC regulators.[17]

Repealing the New Deal Financial Regulatory Structure

In this dissertation the terms "New Deal" and "Depression-era" regulatory structure, or banking systems, interchangeably refer to a particular set of laws and

[16] Jane W. D'Arista, *The Evolution of U.S. Finance: Restructuring Institutions and Markets* (New York: M.E. Sharp, 1994), 370; Broome and Markham, "Before and After," 723-64. For example, the NAIC recommended independent audits of actuaries in setting reserves, but most states did not require this step. But in response to a series of acquisitions of noninsurance businesses in the 1960s, the NAIC approved a model insurance holding company statute. This statue was broadly adopted by most states. The model law imposed restrictions on the affiliation of insurance companies with commercial firms. It also allowed insurance holding companies to manage mutual funds, sell variable annuities and life insurance, manage pension funds, and act as security broker-dealers for their own accounts, but not for the public. Even so, while most states accepted the NAIC recommendations, not all did. However, the NAIC did maintain a joint reporting system for interstate insurers.

[17] Scot J. Paltrow, "The Converted: How Insurance Firms Beat Back an Effort for Stricter Controls," *Wall Street Journal*, Feb. 5, 1998, A1.

regulations. While some of the unique features of the American financial system were in place well before the 1930s, and additional aspects were added as late as the 1950s, the basic structure was codified during the New Deal.

Following the Crash of 1929, subsequent banking panics from 1930-1933, and the onset of Great Depression, the U.S. adopted a comprehensive financial regulatory scheme. That is, a confluence of public policies focused on the financial and housing markets that resulted in the landmark regulatory legislation of the New Deal, including the Federal Home Loan Bank Act of 1932, the Securities Act of 1933, the Banking Act of 1933 (Glass-Steagall Act), the National Housing Act of 1934, the Securities Exchange Act of 1934, and the Banking Act of 1935. Similarly, the Commodity Exchange Act of 1936 was passed to provide oversight of the commodity futures markets, which were thought to be vulnerable to fraud and manipulation.[18]

The New Deal regulatory framework for the financial services industry had several distinct features. For banking in particular, the Pecora Hearings in Congress built the case for dividing investment and commercial banking. The argument was two-fold. First, underwriting stocks was inherently riskier than taking deposits and lending. The view taken by Congress was that commercial banking needed to be separated from riskier activities to protect the bank customer's deposits. Second, proprietary trading on the bank's own accounts posed a potential conflict of interest with advice provided to customers. Again, the view taken by Congress was that separating commercial from

[18] Damon A. Silvers, "Deregulation and the New Financial Architecture," in *The Handbook of The Political Economy of Financial Crises*, eds. Martin H. Wolfson and Gerald A. Epstein (Oxford University Press, 2013), 431-433. See Appendix 5 for the major features of the key legislation that formed the foundation of the New Deal banking, investing, and housing regulatory structure.

investment banking would resolve that conflict. Hence, the Glass-Steagall Act separated commercial and investment banking firms both in terms of ownership and function.[19]

The New Deal banking structure also included the establishment of deposit insurance and controls on interest rates. The premise of deposit insurance was that providing a federal guarantee of deposits would prevent panic among bank customers and avoid future runs. At the same time, Congress sought to prevent banks from speculating with government guaranteed funds by prohibiting banks from underwriting or trading in securities. Instead, banks were only allowed to invest their deposits in mortgages, business lending, and retail loans. Finally, in order to ensure the banks remained viable, Congress directed the Federal Reserve to establish a spread between the interest paid on deposits and retail and mortgage loan rates. Known as "Regulation Q" this interest rate control scheme ensured a reasonable profit for well managed banks while minimizing the risk that banks could overextend themselves by offering excessive rates on deposits.[20]

When banks sought to work around the Glass-Steagall Act in the 1950s by using holding companies to affiliate with both investment banks and insurance underwriters, Congress responded with the Bank Holding Company Act of 1956 (BHCA). This law extended the prohibition of combined commercial and investment banking to the

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[19] Alan D. Morrison and William J. Wilhelm Jr., "The Demise of Investment Banking Partnerships: Theory and Evidence," University of Virginia Law School (February 2005). The riskier investment banks were left as partnerships and not allowed to form as public companies in order to encourage market discipline. The SEC policy change allowing investment banks to be traded as public companies only occurred in 1970, and the last of the major investment banks, Goldman Sachs, did not convert until 2009.

[20] Larry Neal and Eugene N. White, "The Glass–Steagall Act in Historical Perspective," *The Quarterly Review of Economics and Finance* 52, no. 2 (May 2012): 104–13 argue the separation of investment from commercial banking was a necessary precondition for the enactment of federal deposit insurance.

affiliation of those types of institutions within a holding company. In addition, the BHCA specifically prohibited the affiliation of commercial banks with insurance underwriters.

In sum, the New Deal banking system was designed to ensure the safety and reliability of the commercial banking system and home housing market, while providing separate markets for "risky" investment banking and broker-dealer trading requirements as well as insurance underwriting.[21] As a result, for the 66 years from 1933-1999 the U.S. was an exception among major economic powers in requiring the separation of commercial and investment banking. Most other first world banking systems, including those of Germany, Switzerland, Great Britain, and the former British Commonwealth countries, allowed "universal" banking in which the functions defined above for commercial and investment banking were resident in one institution. The U.S. in effect returned to the international norm with the passage of GLBA in 1999.[22]

Incremental Repeal

The New Deal banking regulatory framework was relatively stable until the late 1960s. While U.S. banks applied pressure throughout this period to modify the framework to its advantage, these efforts met with limited success as long as the New Deal policy consensus remained intact. However, that consensus began to crumble in the 1970s. Thereafter, the path of modern banking deregulation from the 1970s through the

[21] The laws also were intended to ensure the transparency of the securities and commodities markets. Unlike banking, which was given close supervisions to prevent and correct issue before they led to failures, the government role in the securities and commodities markets was to ensure they were fair, which it ensured by punishing firms for noncompliance with rules intended to ensure transparency. Government oversight was provided via self-regulatory structures, but the public was left to trade at their own risk.

[22] Jill M. Hendrickson, "The Long and Bumpy Road to Glass-Steagall Reform: A Historical and Evolutionary Analysis of Banking Legislation," *American Journal of Economics and Sociology* 60, no. 4 (October 2001): 850-853; Berger, et al., "The Transformation of the U.S. Banking Industry," 55-56.

1990s reflected a new understanding of the financial failures that led to Glass-Steagall, a dynamic globalized and securitized financial marketplace, the immediate pressures of a failing economy, as well as an information technology revolution. These factors led to an emerging policy consensus among the banking industry, its regulators, and Congress that the New Deal regulatory structure was both archaic and inadequate to regulate modern banking and finance. Over this period, reflecting the evolving policy consensus, federal and state courts generally upheld financial deregulatory steps in support of the U.S. banking industry.[23]

The first thing to understand about the weakening policy consensus in support of the New Deal banking framework was that a growing weight of scholarly research that showed that the security activities of commercial banks were not responsible for banking failures during the Great Depression.[24] Speaking in the late 1980s, the venerated Federal Reserve Board chairman Alan Greenspan stated that, "Research over the past 50 years concludes, contrary to Congress' view at the time, that bank securities activities were not a cause of the Great Depression and that banks with securities affiliates did not fail in

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[23] James R. Barth, R. Dan Bumbaugh Jr., and James A. Wilcox, "The Repeal of Glass-Steagall and the Advent of Broad Banking," *Journal of Economic Perspectives*, Policy Watch, 14, no. 2 (Spring 2000): 191-204. See also Richard H. K. Vietor, *Contrived Competition: Regulation and Deregulation in America* (Cambridge, Mass: Belknap Press of Harvard University Press, 1994), who discussed management responses to the challenges posed by deregulation at firms as diverse as ATT and Bank of America.

[24] George J. Benston, *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered* (New York: Oxford University Press, 1990); Eugene N. White, "Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks," *Explorations in Economic History* 23 (1986): 33–55; and Ivan C. Roten, "Essays on the Underwriting Activities of Commercial Bank Holding Companies." Ph.D., University of Kentucky, 2001.

proportionately greater numbers than banks more generally."[25] His comments signaled to policymakers that they could ease off of Depression-era banking restrictions without causing undue risk to the safety and soundness of the banking system.

A second factor undermining the consensus was the evidence provided by operation of U.S. banks in competition with other "universal" banks in the international arena. That is, since Glass-Steagall did not limit the international operations of U.S. banks, large U.S. commercial banks had been successfully acting as universal banks in foreign markets since 1919, combining investment and commercial banking operations just as their principal foreign competitors did. The examples provided by international comparison as well as the recent experience in the U.S. of commercial banks conducting some securities operations indicated or at least supported the idea that banks could fully integrate with securities businesses in domestic markets without undue risk.[26]

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[25] Alan Greenspan, "Legislative Proposals to Restructure Our Financial System: Hearings on S. 1886 and S. 1891," Before the Senate Committee on Banking, Housing, and Urban Affairs, 100th Cong., 1st Sess. 13 (1987). There is also an extensive body of literature on the causes of the Great Depression. Some notable works include: John K. Galbraith, *The Great Crash 1929* (Boston: Houghton Mifflin Harcourt, 2009) offers the standard interpretation that the Crash caused the Great Depression; while Robert Sobel, *Panic on Wall Street: A History of America's Financial Disasters* (Washington, D.C: Beard Books, 1999) captures the theme of recurring financial panics; Amity Shlaes, *The Forgotten Man: A New History of the Great Depression* (New York: Harper Perennial, 2008) offers a counterpoint that the New Deal prolonged the depression; Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States 1867 – 1960* (Princeton: Princeton University Press, 1993; 1963) represents the original and best monetarist explanation of the Great Depression; Barry J. Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939* (New York: Oxford University Press, 1992) argues the gold standard as implemented was at fault; and Ben Bernanke, *Essays on the Great Depression* (Princeton: Princeton University Press, 2005) provides a well-regarded macroeconomic synthesis.

[26] Barth, Bumbaugh, and Wilcox, "Broad Banking," 192-196. The Edge Act, 12 U.S.C. § 611–631, an amendment in 1919 to the Federal Reserve Act of 1913, permitted U.S. chartered national banks to use subsidiaries to deal in securities outside of the U.S.

Not only did U.S. banks have to compete with large universal banks abroad, but those same foreign banks were competing effectively within the U.S. domestic banking market as well. Lobbyists for the banking industry argued to Congressional members and regulators that their industry needed regulatory relief in order to be able to compete effectively in the world financial markets. In other words, bankers sought ways to employ the sort of flexibility that they had in their international operations to their U.S. domestic operations and were increasingly successful in convincing regulators, the courts, and Congress to provide it.[27]

A third factor driving deregulation was that both commercial and investment banks faced competitive pressures from a growing segment of financial institutions that did not have to comply with Glass-Steagall. During the "stagflationary" 1970s, the economic conditions led to the establishment of innovative financial intermediaries, which were sometimes known as the shadow banking system. As one example, high interest rates made it difficult for banks to lend to commercial customers without violating the interest rate restrictions imposed by Regulation Q. Instead, the public demand for financing was met by various payday lenders, finance companies, and "nonbank" banks that circumvented interest rate restrictions. The business model for commercial banking was becoming untenable without regulatory relief. Indeed, as we will see these economic pressures led to a hidden crisis of banking failures in the 1980s.[28]

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[27] Martin H. Wolfson, "An Institutional Theory of Financial Crises," in *The Handbook of the Political Economy of Financial Crises*, ed. Martin H. Wolfson and Gerald A. Epstein (New York, NY: Oxford University Press, 2013), 186.

[28] The BHCA of 1970 defined a bank as an institution that both took demand deposits and made commercial loans. A "nonbank" bank was a lending institution that was deliberately established to fail one of those two criteria. A "bank" that made only

A fourth issue forcing an updated regulatory framework was the need to accommodate advances in information technologies. After the 1970s, the commercial banking industry saw significant changes from technological innovations that affected how consumers banked, including automated teller machines (ATMs), online banking, and the rapid transfer of both information and funds. Technological innovations created the opportunity to improve profits through efficiency in operations as well as the creation of new products. In some cases, these new capabilities drove deregulation directly, as when customers responded to the convenience of banking with ATMs by demanding that banks to offer more widespread branching.[29]

Technology advances also enabled significant changes to both the commercial and investment banking industries' management of securities, which blurred the line between banking products, securities, and insurance. For example, computing power enabled the creation of new financial instruments such the securitization of traditional banking assets, including mortgage backed securities as well as a myriad of other products such as credit cards and retail loans. Simultaneously, new information technologies gave large corporations the ability to create and maintain their own commercial bonds directly, which provided an alternative to both bank loans and the equities market as a source of funding. More to the point in terms of regulation, the more product lines blurred the less it made sense to artificially keep the financial services industries separate.[30]

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consumer loans or took only savings deposits was not restricted by either Glass-Steagall or the BHCA.

[29] Hendrickson, "Glass-Steagall Reform," 850-853.

[30] Barth, Bumbaugh, and Wilcox, "Broad Banking," 192; Hendrickson, "Glass-Steagall Reform," 850-853.

As a result of these factors, Congress, banking regulators, and the courts had undertaken a significant deregulation of the New Deal financial regulatory structure by the early 1990s. Laws such as the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 eliminated many unique characteristics of U.S. banking, including interest rate restrictions, geographic limitations, and codified distinctions among types of commercial depository banking institutions. In addition, federal regulators had begun to allow banks to encroach on both securities and insurance underwriting and sales. This incremental repeal of the Depression-era banking restrictions continued with legislative efforts to repeal Glass-Steagall.[31]

Glass-Steagall Repeal Efforts in the 1990s

Even as deregulation progressed, the separation among banking, securities, and insurance separate remained. Despite attempts by Congressman James Leach, R-IA, throughout the 1990s to pass a legislative repeal of Glass-Steagall, it was difficult to build a legislative consensus. Why? Legislative resistance primarily reflected the fact that the three primary financial services industries were at odds with each other over the path forward. For example, the large commercial banks were long-time advocates of Glass-Steagall repeal but opposed provisions that would limit their access to insurance markets. Commercial bankers also worried about the emergence of unitary thrift holding

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[31] William S. Haraf and Rose Marie Kushmeider, "Restructuring Financial Markets," in *Restructuring Banking & Financial Services in America*, eds. William S. Haraf and Rose Marie Kushmeider (Washington, D.C.: American Enterprise Institute for Public Policy Research,1988), 1-26; Barth, Bumbaugh, and Wilcox, "Broad Banking," 192-196. Beginning in 1987, the Federal Reserve began to interpret Section 20 of the Glass-Steagall Act to allow the securities subsidiaries of Bank Holding Companies to engage in limited underwriting and dealings in municipal revenue bonds, mortgage related securities, consumer-receivable securities, and commercial paper. Since these activities technically bank-ineligible they were known as "Section 20 exceptions."

companies, which were similar to bank holding companies but instead owned a savings and loan institutions. The banks were concerned that the unitary thrift construct would allow other financial institutions as well as retail corporations to enter banking.[32]

For their part, investment banks wanted access to commercial banking and insurance markets but were concerned that deposit insurance gave commercial banks a competitive advantage. Similarly, insurance companies opposed any legislation that opened the insurance market to competition with commercial banks. Insurance agents in particular sought to preserve state regulation of insurance to prevent banks from entering insurance sales without the regulatory restrictions faced by agents in each state. Finally, the small banks consistently opposed Glass Steagall repeal out of concern that they could not compete with the resulting powerful national banks.[33]

The stalemate in Congress over the repeal of Glass-Steagall came to a head when the Federal Reserve authorized Citicorp bank and Travelers insurance company to merge into Citigroup in 1998. Despite the Federal Reserve's regulatory authority to approve mergers involving bank holding companies, Glass-Steagall was still in effect. This meant that either Congress would have to modify the Glass-Steagall restrictions or the new

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[32] Savings and Loan Holding Company Act, 12 U.S.C. section 1730a (1994).

[33] Hendrickson, "Glass-Steagall Reform," 863-868. See also Appendix 4 in this proposal for a listing of the major trade associations that represented the diverse financial industry players. Trade associations and other lobbyists served not only to keep their members informed of new developments in law, regulations, and legal opinions, but also of course to advocate their members' interests. But trade associations could be at odds even within the banking community itself. For example, the American Bankers Association generally served the entire banking community, but was biased towards large banks, while Independent Community Bankers of America sought to exclusively represent small banks. Similarly, the Securities Industry Association represents investment banks, securities brokers, and investment companies, while the Investment Company Institute focuses exclusively on representing investment companies. And within the insurance industry American Council of Life Insurers was sometimes opposed to the American Insurance Association, which represented property insurers.

Citigroup structure would have to be unwound. The Federal Reserve's approval of this merger crystalized several points. Not only did the Federal Reserve demonstrate conclusively that it was prepared to act without Congress, but it put Congress in the position of having to protect a major deal that put the U.S. back at the top of the world banking charts. In addition, the approval had the effect of flipping the narrative in that Citicorp, formerly an opponent of repealing Glass-Steagall during the tenure of CEO John Reed, now forcefully advocated repeal.

The approval of the Citigroup merger took place at a point when Congress was more receptive to repealing Glass-Steagall and had a significant impact on the debate. Senator Alphonse D'Amato, R-NY, lost his reelection bid and had been replaced as Chair of the Senate Banking Committee by Senator Phil Gramm, R-TX, a supporter of financial deregulation in the name of "free markets." Once Gramm teamed with Leach to negotiate a final agreement with all parties—which included the House Commerce Committee headed by Congressman Thomas Bliley, R-VA, the Clinton administration, federal and state regulators, as well as all the major financial industry trade associations - these two powerful committee chairs were finally able to bring Glass-Steagall repeal to the forefront of the deregulation debate.[34]

Hence, by 1999 the stage was set for repeal of Glass-Steagall but significant impediments remained. Congress finally recognized the need for financial services modernization, but was unable to complete its work until the banks, broker-dealers, and insurers agreed on an approach. Additionally, key policy-makers in Congress, the Administration, and among the regulatory community had to come to terms with the

[34] Hendrickson, "Glass-Steagall Reform," 869-872.

extent of modernization. That is, would it continue the evolutionary trends in banking deregulation and simply repeal Glass-Steagall, or become a broader reform of financial services? This dissertation is the story of how Congress, the Administration, the regulatory state, and industry dealt with those remaining challenges.

OTC Derivatives and Financial Services Modernization

To the extent that the financial services modernization debate remained focused on repeal of Glass-Steagall, it failed to provide necessary regulatory reform to accommodate other important developments in financial markets. That is, entirely new financial products were appearing that were never envisioned in the New Deal banking regulatory structure. In the 1990s, new over-the-counter (OTC) markets were created in financial derivatives. These increasingly sophisticated instruments allowed companies and banks to hedge risks, from exchange rate risk for overseas trades to interest rate risks created by variable rate loans. At first executed by banks and securities broker-dealers as hedges for both their own investments as well for their customers, these derivatives were eventually traded as investments by privately held hedge funds. This transition was important, because while it was reasonable to argue that the SEC could regulate new securities products traded by broker-dealers, and bank examiners could do the same for derivatives employed by banks, there was no regulatory agency or commission to regulate investments in the OTC derivatives market itself.

To understand why not, one must return to the New Deal financial regulatory structure. The Commodity Exchange Act of 1936 (CEA) established the regulation of commodity and futures markets, which were exchanges primarily based in Chicago. The CEA explicitly recognized that these futures markets required regulation because, as with securities markets, the commodity exchanges were open for the general public to trade but were run by parties with valuable insider information. Hence the exchanges were regulated in order to protect the public, and especially agrarian interests, from fraud and the sort of pricing irregularities that can arise from information asymmetries. However, regulation for commodities and futures markets was subject to its own Congressional oversight albeit from the agricultural committees rather than the banking committees. The crucial point here is that while the CEA was part of the New Deal, Congress established the regulation of commodities outside the financial services regulatory structure.

Disputes over how or even if OTC derivatives should be regulated as securities or commodities became an important part of the financial services modernization story. Over time the CEA was modernized such as when legislators shifted oversight authority from the Agriculture Department to the newly established Commodity Futures Trade Commission (CFTC) in 1974. Yet despite the close similarity between derivatives and futures, Congress declined to update the CEA to include the regulation of the over-the-counter derivatives markets during the 1990s.

In one sense the stalemate on derivatives represented a difference in opinion among key policy makers. When the Chair of the CFTC, Brooksley Born, suggested that the CFTC undertake an SEC like role in overseeing the OTC derivatives market, she was opposed by her peers. Fed Chairman Alan Greenspan, SEC Chairman Arthur Levitt, and Treasury Secretary Robert Rubin jointly rejected her views on the premise that applying the CEA ruleset to OTC derivatives would create legal uncertainty for the derivatives contracts, which were individually written between counterparties and not set up to be cleared on an exchange. Although it carried the day, this argument conspicuously failed to deal with the issue of what regulation if any was appropriate for the OTC derivative market.

GLBA itself was basically silent on the issue of important new financial services, institutions, and product, including hedge funds and Over-the-Counter (OTC) derivatives. However, the regulatory structure established by GLBA became the foundation on which the Commodity Futures Modernization Act (CFMA) was built. That is, under GLBA the financial services were regulated by function: banking by the traditional bank authorities, securities by the SEC and in some cases state commissioners, and insurance by state insurance commissioners. As a result, the CFMA was designed to allocate the regulation of derivatives in banking to the bank examiners, and derivatives in securities markets to the SEC, with associated self-regulatory organizations.

This was a failure rather than a triumph. Legal certainty for OTC derivatives was established, which was all to the good. However, Congress allowed several important regulatory shortfalls to persist in the CFMA by following the functional regulatory structure established by GLBA. Because in effect OTC derivatives were only regulated at the individual institutional level, such as each bank or broker-dealer, derivatives as investments remained unregulated at the federal level for both insurance companies and hedge funds. This combined failure of GLBA and CFMA meant that the overall OTC derivatives market itself was left unregulated, which was likely a crucial contributing cause to the financial crisis of 2008. Contrary to the traditional narrative, it was this failure to establish an appropriate regulatory regime for derivatives rather than the deregulatory nature of GLBA that undermined the safety and soundness of the U.S. financial system entering the 2000s.

Organization of the Narrative

This is a policy history of financial services modernization legislation. The research approach here relies on the historian's methodology and tools; that is, the reconstruction of the evolving institutional and policy context through primary historical sources and archival research.

Chapter 1 defines the relevant historiography, surveys the related literature, and discusses the ways in which this dissertation advances the scholarly debate. Of note, it demonstrates that the common question asked of GLBA – if its deregulatory actions caused later financial failures – is misplaced. GLBA repealed Glass-Steagall, but the deregulation it achieved was a codification of earlier efforts and not as transformative as the literature implies. Instead, the relevant consequence of financial modernization, broadly speaking, was the failure to impose regulatory reform to account for new financial markets, institutions, and products.

Chapter 2 highlights the secular trend of deregulation and the impact of market forces, including the efforts of powerful large commercial banks, in undermining the original conditions that supported the original New Deal financial regulatory structure. It demonstrates that in many ways Glass-Steagall had in fact been severely undermined by a succession of regulatory and judicial decisions. This chapter lays out the evolutionary nature of banking deregulation over time and serves as a backdrop for the direct efforts to repeal Glass-Steagall through legislation.

Chapter 3 introduces the modern legislative campaign to repeal Glass-Steagall. It demonstrates that there was a remarkable consistency in the core legislation through successive attempts to remove legislative restrictions on the affiliation of banking, securities, and insurance. Additionally, Chapter 3 identifies the major issues that brought the various institutional players to common agreement on the legislation. In particular, it makes clear that there were key structural factors that served as impediments to broader regulatory reform, leading financial modernization to focus primarily on repeal of Glass-Steagall.

Chapter 4 considers the issues introduced in the previous two chapters, and evaluates the roles played by the various institutional players in finally passing the Financial Services Modernization Act of 1999, or Gramm Leach Bliley Act (GLBA). Specifically, it addresses the flow of politics, people, and policies necessary to actually pass the law as a policy decision. In particular, it builds on previous legislative histories to include financial services regulatory agencies and industry trade associations as discrete veto points in the legislative process. The need to find common ground ensured that GLBA largely maintained the financial system's underlying regulatory structure even as it repealed the restrictions on affiliations among banking, securities, and insurance.[35]

Chapter 5 turns to the debate over how to regulate OTC derivatives and the passage of the CFMA in the context of updating the Commodity Exchange Act (CEA). The discussion addresses how this issue is related to financial services modernization. Additionally, it lays out the institutional factors that ensured this debate was conducted in parallel but separately from the repeal of Glass Steagall. This chapter concludes with the failure to require the incorporation of relevant safety and soundness regulations for

[35] Julian E. Zelizer, *Taxing America: Wilbur D. Mills, Congress, and the State, 1945-1975* (Cambridge: Cambridge University Press, 2000) provides an excellent example in the case of tax expenditures of an APD institutional analysis of congressional processes, including the power of committee chairs and the relevant policy community.

derivatives into the post-GLBA financial services regulatory structure, which was arguably the most significant failure of the financial modernization efforts.

Finally, Chapter 6 serves as the conclusion of the dissertation. Working from a policy development perspective, it recounts the political factors and enduring thematic explanations for the policy decisions that shaped both GLBA and the CFMA. It includes an epilogue in which the consequences of financial modernization from the 106th Congress are assessed against their impact on the financial crisis of 2008.

Common Themes

Viewed narrowly, as a specific policy decision, GLBA achieved its principle objective. To wit, it codified the ability of banks, securities firms, and insurance underwriters to affiliate both in business and in the creation of new investment products. Viewed more broadly in the context of policy developments over time, the financial services modernization legislation of the 106th Congress, to include the CFMA, actually may be seen as an inflection point in several longer-term interrelated thematic developments.

First, the final form of GLBA was significantly driven by the fragmented U.S. policy-making process. Despite decades of effort by the commercial banking community, and the evolving concurrence by the financial regulatory community that Glass-Steagall should be repealed, the actual legislative repeal was by no means inevitable. Even as market conditions evolved to demonstrate that the separation of banking, securities, and insurance had been undercut by regulatory actions and judicial decisions, power brokers and policy entrepreneurs maneuvered for position in order to incorporate their particular issues. Congressional committee chairs, each with their own policy preferences, led the legislative efforts. They were in turn constrained by the interests of the regulatory state, the Clinton Administration, and the lobbying power of the financial trade associations as well as several large financial institutions, all of which exercised veto power (literally in the case of the administration) at some point in the legislative process. The result was legislation focused on its core purpose, repeal of Glass-Steagall, which despite rhetoric to the contrary was severely constrained in in terms of actual imposed deregulation.

Second, the self-interests of the banking, securities, and insurance industries constrained GLBA to concentrate just on the repeal of Glass-Steagall, and prevented the either GLBA or the CFMA from taking any effective action to regulate the OTC derivatives market. In particular, coming out of the disastrous decade of the 1980s, commercial bankers sought to repeal Glass-Steagall as a way to improve their business base and profits. Denied legislative relief, they turned to a very successful campaign of regulatory and judicial repeal. Interestingly enough, it was their success on this front that brought the investment banks and insurance firms to leverage the previously ignored unitary thrift holding company (UTHC) loophole as a counter to the commercial banks' expansion. This UTHC gambit opened the policy window in Congress as all the financial services now believed they could enter negotiations on equal grounds. Certainly, bankers had no qualms preventing a law from passing in the 105th Congress when it did not close the unitary thrift loophole. Similarly, when the large banks and securities firms created complex risk-management models to manage their own risks, and convinced regulators to merely supervise the banks' implementation, they developed a strong incentive to prevent regulation of the OTC derivatives markets because self-regulation enabled them to leverage off-balance sheet assets and hedges to justify low levels of capital reserves to leverage corporate profits.

A third common theme shaping both GLBA and the CFMA was a free-market bias among the financial services industry, key regulators, as well as Congress and the Administration. Encouraged by the financial successes of the 1990s and supported by neoliberal speculation that financialization and securitization changed the economy in fundamental ways, this changing ideological consensus created expectations of market discipline for financial institutions that, from the perspective of policymakers, obviated the need for government regulation of new financial markets, institutions, and products. This viewpoint represented a triumph of hope over long-term experience. That is, while individual financial entities are sometimes disciplined in the markets, government oversight is required to prevent information asymmetries and to ensure the functioning of interconnected financial services in the market as a whole. Unfortunately, in developing the post-GLBA financial regulatory structure policymakers repeatedly indicated their nominal awareness of potentially threats to the financial system yet deliberately forbore regulatory action based on the expectation of market self-discipline.[36]

The fourth common theme was the interrelationship between the regulatory state and financial services industries, reflecting the unique American tendency towards associational relationships, which resulted in the functional regulation compromise in GLBA. In other words, financial regulatory authority after GLBA would be assigned by function. That is, banks would be regulated by their historical examiners, whether federal or state; securities by the SEC and associated SROs, and in some cases by states; and

[36] Alan Greenspan, Lawrence H. Summers, William J. Rainer, and Arthur Levitt, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," The President's Working Group on Financial Markets, Washington, D.C. (November 1999). Greenspan's free market advocacy is well chronicled, but this official report is entirely premised on the ability of market discipline to enforce public policy objectives.

insurance by state commissioners, also coordinated nationally through SROs.[37] This compromise was required in order to get to the respective financial services industries to agree to the repeal of Glass-Steagall. However, as explained below, it had the unfortunate consequence of tying deregulation to existing regulatory structures and all but ensuring that the repeal was not going to result in significant reform.

The functional regulation compromise was necessary because both the insurance and securities industries were opposed to strong oversight by the Federal Reserve, which was likely under the holding company structure favored by the congressional committee chairs. The securities industry, with its tradition of SROs, had no interest in the sort of oversight provided by bank examiners. The SEC staff and leadership believed—incorrectly as it turned out—that a functional regulation approach would eliminate the exceptions previously granted for securities underwritten by banks. Additionally, the insurance industry, with its tradition of state regulation and public-private cooperative oversight, sought to prevent insurance sales in banks from being separately regulated by the Office of the Comptroller of the Currency, fearing that such a move would privilege banks in competition with insurance agents.

As a result, little if any of the underlying regulations actually changed after the law was implemented since the regulatory relationships were preserved under GLBA. As a practical matter, this meant that GLBA was far less transformative than is commonly

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[37] Edward G. Eisert, "Overview of Financial Modernization Legislation from a Securities Regulatory Perspective: Broker-Dealer and Investment Management Activities," *Banking & Financial Services Policy Report* 19, no. 9 (5/1/2000): 8-9. In defining functional regulation, GLBA is careful to limit the authority of the Federal Reserve over nonbanking affiliates of the holding company. Notionally, while the Federal Reserve has oversight over financial holding companies, the appropriate functional regulator of security, banking, or insurance activities, whether state, federal, or both, has authority over the security or insurance functions within the holding company affiliates.

understood. Yes, it repealed Glass-Steagall. But it did so at the cost of allowing the underlying regulatory rulesets for banks, broker-dealers, and insurance firms to remain status quo. This regulatory structure was carried over to the CFMA, with OTC derivatives nominally governed by the functional regulator of the financial institution (e.g., bank or broker-dealer). However, no provision was made for a federal regulator of the OTC derivatives market as a whole, or for regulation of previously unregulated institutions such as hedge funds.

Fifth, and finally, the repeal of Glass-Steagall, as well as the exclusion of derivatives from the CEA, were both intrinsically focused on the Depression-era regulatory framework.[38] The laws passed in the 1930s, as amended, continued to drive policymakers at the turn of the 21st century. As discussed under functional regulation, one manifestation was that despite the repeal of Glass-Steagall, the underlying New Deal regulatory structure remained substantially intact. But there is a separate and equally important practical manifestation of the focus on New Deal regulatory structures. Specifically, the policy community's concern with protecting the federal safety net, consisting of deposit insurance, the payment system, and the Federal Reserve as the payer of last resort, led it to discount important the need to adopt other safety and soundness reforms as part of the repeal debate.

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[38] Barry J. Eichengreen, *Hall of Mirrors: The Great Depression, the Great Recession, and the Uses-and Misuses-of History* (New York, NY: Oxford University Press, 2015), 68. One of his key insights was that a focus on the Great Depression led policy-makers in 2008-2009 to inadvertently prolong the Great Recession. Here I modify Eichengreen's conclusion to suggest that a dedication to the regulatory structure created during the Great Depression kept the policy community in 1999-2000 from recognizing the need for a new regulatory approach; that is, in addition to or instead of commercial banks financial modernization should have focused on derivatives, hedge funds, money market funds, and special purpose vehicles.

Recall that despite the lofty phrasing, financial services modernization was really about repealing Glass-Steagall. The Depression-era perspective on financial regulation unfortunately perpetuated the misconception that the safety of the banking system could be preserved by isolating riskier types of financial institutions, like investment banking, from the governance, risk management, and capital reserves of banks. This blinded the policy community to the possibility, perhaps even the necessity, of regulatory innovations to incorporate new financial institutions, instruments, and markets to mitigate systemic risks to financial across the markets. As a result, steps that were considered at the time, such as electronic exchanges to serve as clearing houses for OTC derivatives, were not required by Congress or imposed by the regulatory agencies and commissions who could have done so within their own statutory limits. Similarly, the focus on the structural separation of commercial and investment banking inhibited consideration of additional safety and soundness regulations appropriate for a banking system now intertwined with "too big to fail" financial holding companies.[39]

Conclusion: A Historic Missed Opportunity

This dissertation demonstrates that while GLBA is best viewed as the culmination of evolutionary changes in the Glass-Steagall framework, ultimately the legislation failed to comprehensively restructure regulation in order to provide effective governance for the modern financial markets. Hence GLBA represented a missed opportunity for truly

[39] Jonathan R. Macey, Geoffrey P. Miller, and Richard Scott Carnell, *Banking Law and Regulation*, 3rd ed. (Gaithersburg: Aspen Law & Business, 2001), 275. The phrase "safety and soundness" represents a single concept rather than two, and it is focused on prudent management practices to keep bank and other financial institutions healthy. Although widely used, in a regulatory sense it is most broadly applied as restrictions and requirements to keep federally insured depository institutions safe and sound. These measures include: 1) capital requirements; 2) prompt corrective action; 3) limits on loans to one borrower; 4) interbank credit exposure limits; 5) insider lending restrictions; and 6) limits on transaction between banks and affiliated companies.

innovative reform. As discussed previously, several common themes or factors provided structural impediments to institutional reform and made it difficult for policymakers to understand the oversight they were making. Given the objective to enact financial services reform that enabled market competition where appropriate by allowing the affiliation of banking, securities, and insurance firms, the historical omission was the failure to also incorporate governmental oversight over dynamic new financial institutions and markets. These included hedge funds and OTC derivatives, both of which represented systemic risks to the traditional financial services industries when considered as markets and not merely in terms of transactions.

Despite the fact that GLBA achieved its stated intent of repealing the Glass-Steagall restrictions preventing the affiliation of banking, securities, and insurance, when considered together with the other financial modernization legislation of the 106th Congress (i.e., the CFMA) it represented a public policy failure to ensure the future safety and soundness of the financial system.

Chapter 1: Literature Review

Exploring the passage of the Gramm Leach Bliley Act (GLBA) requires an understanding of a number of approaches in the literature, including scholarship in American Political Development, histories of banking deregulation, and new approaches to the history of capitalism, which as a field has subsumed approaches previously labeled as economic history, business history, and history of political economy.[40] This narrative will interweave these various approaches to present an institutionally grounded historical analysis of financial regulation and policy that incorporates economic trends such as financialization and the emergence of neoliberalism. Hence, while making a revisionist argument about the impact of financial deregulation, this dissertation will draw on a variety of scholarly sub-fields to argue that both GLBA and the Commodity Futures Modernization Act (CFMA) actually codified and strengthened the authorities of the existing regulatory agencies while simultaneously omitting safety and soundness measures necessary to protect the new financial system being overlooked or deliberately omitted.

Policy History

Policy history straddles the fields of history, political science, and public policy. Julian Zelizer once observed that the common characteristic among those who study policy history is that they organize their subjects and narratives around the development and implementation of policy.[41] Interest in policy history declined in the 1970s, as historians and scholars turned from top-down topics that privileged the narratives of

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[40] Sven Beckert, S., et al., Interchange: The History of Capitalism. *Journal of American History 101,* no.2 (2014): 503–536.

[41] Julian E. Zelizer, “Clio’s Lost Tribe: Public Policy History Since 1978,” *Journal of Policy History* 12, no. 3 (2000): 369–94.

"great white men" such as political and diplomatic history to focus on social and cultural history.[42] Hugh Davis Graham suggested that the field of political history was uniquely affected during the 1970s because, in addition to the social and cultural upheavals of the decade, the evolving regulatory state quickly outstripped the explanatory power of traditional political analysis. Instead of further developing the fields of public administration, econometrics, regulatory law, and public administration to explain these changes, the new generation of historians turned away from analyzing government policy toward "bottom up" history to study, for example, social movements.[43]

In the 1980s, policy history was characterized by William Leuchtenberg's perceptive observation that the next frontier in the field would be, instead of social forces and social values, the history of the American state.[44] Amidst positive signs, such as the founding of *The Journal of Policy History* in 1989, critical work was being done to "bring the state back in" as a crucial factor in understanding policy developments.[45] Both Graham and Zelizer agreed that this new approach to policy history, or American

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[42] Peter Novick, *That Noble Dream: The "Objectivity Question" and the American Historical Profession* (Cambridge: Cambridge University Press, 1988), 523-524; Julian E. Zelizer, "History and Political Science: Together Again?" *Journal of Policy History* 16, no. 2 (April 2004): 127.

[43] Hugh Davis Graham, "The Stunted Career of Policy History: A Critique and an Agenda," *The Public Historian* 15, no. 2 (1993): 27-29. See also Hugh Davis Graham, *The Civil Rights Era: Origins and Development of National Policy, 1960-1972* (New York: Oxford University Press, 1990) for an example of administrative history as applied to the civil rights movement. He identifies ways in which government agencies and the courts altered the original meaning of the 1960s-era civil rights legislation, which resonates with my own observations in the field of banking.

[44] William Leuchtenburg, "The Pertinence of Political History: Reflections on the Significance of the State in America," *The Journal of American History*, 3 (1986): 589.

[45] Graham, "The Stunted Career of Policy History," 32. See George Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science* 2 (1971): 3–21; Sam Peltzman, "Toward a More General Theory of Regulation," *Journal of Law & Economics* 19 (1976): 211–240 for classic statements of special interest group theory of regulation.

Political Development (APD), was institutionalized with the establishment of the "History and Politics" section of the American Political Science Association in 1988 and the founding of the journal *Studies in American Political Development*.[46]

American Political Development

As a field, APD evolved in response to the perceived shortfalls in several previously well accepted traditions in American historiography of the state, including classical liberalism, pluralism, and progressivism. It challenged historical explanations of the American state rooted in a social consensus supporting the Lockean view of liberalism.[47] Similarly, it countered theories of the state based on pluralism, or the notion that policy was the product of lobbying and interactions among interest groups.[48] APD sought to move beyond these liberal and pluralistic traditions about government and society to consider the roles of actors and institutions within the state itself.[49]

APD was also a response to the progressive tradition in American history, which viewed the development of a strong state as necessary to enact the reforms necessary to mitigate the effects of modernization and industrialization. The so-called "Progressive synthesis" favorably presented strong American leaders, typically Presidents, who used the accretion of state power to battle conservative business and social interest groups. Some scholars viewed state building as cyclical but in general the progressive approach

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[46] Julian E. Zelizer, "Introduction: New Directions in Policy History," *Journal of Policy History* 17, no. 1 (January 2005): 1–11; Graham, "The Stunted Career of Policy History," 32.

[47] Louis Hartz, *The Liberal Tradition in America: An Interpretation of American Political Thought Since the Revolution* (New York: Harcourt Brace, 1955).

[48] R. A. Dahl, *Pluralist Democracy in the United States: Conflict and Consent* (Chicago: Rand McNally, 1967) is a classic presentation of the scholarly traditions in pluralism, or interactions among multiple interest groups in addition to political parties or other similar models.

[49] Karen Orren and Stephen Skowronek, *The Search for American Political Development* (Cambridge, UK; New York: Cambridge University Press, 2004), 3.

was presented as dualistic narrative; e.g., Conservative versus Liberal, Republicans versus Democrats, or business versus labor. Historians have applied the lens of progressivism to analyses of presidential administrations, party politics, and electoral cycles. Although often written about institutions, these studies nevertheless lacked consideration of the institutions themselves as actors, which caused them to overlook important details about policy formation.[50]

Scholars have replaced the historical frames of liberalism, pluralism, and progressivism with at least three sometimes overlapping approaches to APD: the organizational synthesis; new institutionalist approaches; and what Brian Balogh has termed the associational synthesis.[51] Although the literature of these three approaches to APD includes no specific studies in banking or financial regulation, this review will consider how each offers insight into banking deregulation~~.~~

The Organizational Synthesis

In contrast with progressive analyses, which tended to focus on ideological differences through policy conflicts, historians in the mid-twentieth century began to analyze reform in the context of how the private sector interacted with the government. This approach became known as the "organizational synthesis." It differed from previous institutional approaches by stressing universal trends rather than particular political or economic organizations. Louis Galambos, a leading business and economic historian,

[50] Arthur M. Schlesinger, *New Viewpoints in American History* (New York: Macmillan, 1922); Charles A. Beard and M. R. Beard, *The Rise of American Civilization,* Vol. 2 (New York: Macmillan, 1927); Arthur M. Schlesinger, *Paths to the Present* (New York: Houghton Mifflin, 1949); Richard Hofstadter, *The Age of Reform: From Bryan to F.D.R*. (New York: Vintage Books, 1955); and W.D. Burnham, *Critical Elections and the Mainspring of American Politics* (New York: Norton, 1970).

[51] Brian Balogh, *The Associational State: American Governance in the Twentieth Century* (Philadelphia: University of Pennsylvania Press, 2015), 4.

concluded that the most important shift in American society was the evolution of a more rational and hierarchical bureaucratic society. The key insight here was that organizations have their own bureaucratic institutions and their own persistence that were necessary aspects of their interrelationship with society, government, and the economy.[52]

One important thread of the organizational synthesis was the study of managerial capitalism, with a focus on modern business enterprise. Alfred Chandler argued that the shift in corporate business practice to managerial capitalism was a distinctly new phase of democratic capitalism. His seminal work highlighted the burgeoning principal-agent problem in American business. That is, as corporations and institutions were increasingly led by managers rather than owners, the interests of the corporations began to diverge from that of society.[53] This insight was a precursor to the use of concepts like financialization and securitization to explain the late 20th century movement of corporate managers seeking to maximize profit and insulate the corporation from external forces such as regulation, social change, ideology and politics.

The managerial capitalism aspect of the organizational synthesis may be applied to banking as well by reflecting the story of powerful corporate institutions in conflict with the regulatory state. For example, New Deal banking laws, seen through the lens of the organizational synthesis, sought in effect to convert the commercial banks to be public-private partnerships. That is, banks were intended to meet the twin public policy goals of

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[52] Louis Galambos, "The Emerging Organizational Synthesis in Modern American History," *Business History Review*, *44* (1970): 279–290; Robert H. Wiebe, *The Search for Order: 1877 – 1920* (New York: Hill and Wang, 1967). Wiebe focused on the importance of an emerging professionalism in American organizations, and captured the governmental, business, and social trends inherent in an emerging industrial society.

[53] Alfred D. Chandler, *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, MA: Belknap Press of Harvard University Press, 1977). Chandler does not concern himself much with politics in his writings.

capital formation and serving as a source of retail and mortgage loans. In return, the federal government would guarantee the industry's stability with deposit insurance, which protected the savings of Americans and provided social and economic stability by mitigating banking panics. The quid pro quo was a separation of commercial banks from other forms of activity, such as underwriting securities and insurance, which Congress deemed risky to the solvency of both commercial banks and the government's deposit insurance fund. Unlike commercial bank deposits, the government did not explicitly guarantee investments in these riskier activities. Congress instead adopted a compliance-based scheme that largely left these markets to self-regulation, with enforcement by the Securities Exchange Commission. This dual approach shaped regulation of financial services into the 21st century.[54]

As regards the repeal of Glass-Steagall in the context of the organizational synthesis, this dissertation examines the activities of commercial and investment banks as well as insurance companies that were actively involved in attempting to influence the legislative process. Commercial banks in particular responded to changing market forces by seeking to redefine the New Deal social bargain in Congress, with regulators, and through the courts. Similarly, insurance and securities firms defended their protected spheres against the onslaught of bank pressure, only seriously engaging in legislative repeal efforts once it became clear the New Deal framework was severely compromised

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[54] Charles W. Calomiris, "Lessons from the Great Depression," *Journal of Economic Literature* 29, no. 4 (December 1991): 1779–82.

by regulators and the courts. As we will see, the brokers and insurers were successful in meeting their goal of minimizing the impact of the repeal.[55]

The organizational synthesis as historiography also provides a context for understanding the perspective of the regulatory state, particularly representatives of the Federal Reserve and the Office of the Comptroller of the Currency, in conversation with the financial services industry. Their judgement that the new dynamics of the economy and financial system of the 1990s required Glass-Steagall to be repealed ultimately determined the outcome of the debate by forcing the hand of Congress through regulatory and judicial action.

Furthermore, as we will see the flawed collective judgement of other key regulatory agencies, including the Securities Exchange Commission and state insurance commissioners as well as bank examiners, also shaped the post-repeal regulatory structure. Indeed, one of the defining aspects of the regulatory structure imposed by GLBA– the retention by the regulatory agencies of their current authorities over their respective industries and financial functions– continued to be driven by the public-private patterns of governance established during the New Deal.

Bringing in the State

Returning to the evolution of APD, in the 1980s scholars began to explore different aspects of power within the federal government by considering the state itself as an actor.[56] Some challenged progressive assumptions about presidential decision-making,

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[55] Larry Neal and Eugene N. White, "The Glass–Steagall Act in Historical Perspective," *The Quarterly Review of Economics and Finance* 52, no. 2 (May 2012): 104–13.

[56] Stephen Skowronek, *Building a New American State: The Expansion of National Administrative Capacities, 1877-1920* (New York: Cambridge University Press, 1982), 4-14; Margaret Weir, Ann Orloff, and Theda Skocpol, (Eds.), *The Politics of Social Policy*

while others examined the role of the post-WWII Congress, and the particular institutional arrangements that allowed key legislators to retain powerful committee chairs for long periods, as the enabling mechanism for both liberal and conservative legislators to expand the state.[57] Similarly, new studies examined the Warren Court and how it significantly increased the role of the federal government in protecting constitutional rights, not on the basis of constitutional theory, but specifically to conform to values that had broad national support.[58] Finally, some scholars contended that a focus on legislative and judicial efforts was insufficient to explain the growing power of the state, and considered alternatives such as the development of bureaucratic autonomy.[59]

Much of this later scholarship rested on a seminal analysis about "bringing the state back in" by Theda Skocpol. She challenged the pluralistic approaches to APD in the 1960s and 1970s to argue that the structure of the state and its organizational capacity

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in the United States (Princeton: Princeton University Press, 1988), 4-25; Skocpol, *Protecting Soldiers and Mothers: The Political Origins of Social Policy in the United States* (Cambridge, MA: Belknap Press of Harvard University Press, 1992), 525-531; and Eldon Eisenach, "Liberal Citizenship and American National Identity," *Studies in American Political Development*, 13, 1 (1999): 206.

[57] Stephen Skowronek, *The Politics Presidents Make: Leadership from John Adams to George Bush* (Cambridge, MA: Belknap Press of Harvard University Press, 1993), 4-7; Julian E. Zelizer, *Taxing America: Wilbur D. Mills, Congress, and the State, 1945-1975* (New York: Cambridge University Press, 2000), 6-16.

[58] Lucas A. Powe, *The Warren Court and American Politics* (Cambridge, MA: Harvard University Press, 2000).

[59] Daniel P. Carpenter, *The Forging of Bureaucratic Autonomy: Reputations, Networks, and Policy Innovation in Executive Agencies, 1862-1928* (Princeton: Princeton University Press, 2001), 353. He defines bureaucratic autonomy as the ability of the bureaucracy to set policy in ways that could not be reversed by politicians or the courts, and argues that two conditions are necessary. First, it requires the establishment of political legitimacy through expertise, efficiency, moral standing, and organizational capacity. Second, multiple networks among professional associations, the media, and other interest groups must be established to create support outside of government. If both could be established, then key individuals within the bureaucracies were well positioned to be policy entrepreneurs.

explained policy outcomes. In particular, her insight was that the state or its agents should be viewed as autonomous actors that contended with other social and political actors to establish governmental policies.[60] Skocpol's approach remains applicable to this analysis of the legislative efforts to repeal Glass-Steagall. In fact, one of the key arguments here is that Congress was unable to break free from the regulatory structure that evolved from the Depression-era laws because key regulatory leaders had the capacity and willingness to resist the implementation of a new regulatory paradigm.[61]

There are a number of studies describing the evolution of the regulatory structure for banking in the U.S.[62] Additionally there exists a plethora of both scholarly and journalistic histories about relevant regulatory institutions such as the Federal Reserve and Securities and Exchange Commission.[63] However, these accounts have tended to be

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[60] Theda Skocpol, "Bringing the State Back In: Strategies of Analysis in Current Research," in *Bringing the State Back In,* eds. B. Evans, D. Reuschmeyer, and T. Skocpol (New York: Cambridge University Press, 1985), 3-37.

[61] Jonathan R. Macey, Geoffrey P. Miller, and Richard Scott Carnell, *Banking Law and Regulation* (Gaithersburg: Aspen Law & Business, 2001), 77-79, 250-57. See also Appendix 3 for a listing of the key regulatory agencies. These regulators often sought to influence Congress. Many important federal agencies, including the Federal Reserve and SEC maintain congressional liaison offices. And senior administration officials cultivated relationships with members of Congress as a standard practice. Similarly, state regulators combined to exert influence through associations such as the Conference of State Supervisors and sought to leverage organizations such as the National Governors Association.

[62] Macey, Miller, and Carnell, *Banking Law and Regulation*, 2-38; Spong, *Banking Regulation,* 15-33; Anna J. Schwartz, "Financial Stability and the Federal Safety Net," in *Restructuring Banking & Financial Services in America*, eds. William S. Haraf and Rose Marie Kushmeider (Washington, D.C.: American Enterprise Institute for Public Policy Research,1988), 34-62.

[63] Roger Lowenstein, *America's Bank: The Epic Struggle to Create the Federal Reserve* (New York: Penguin Press, 2015) for a journalistic approach; Allan H. Meltzer, *A History of the Federal Reserve. Vol. 1: 1913 - 1951* (Chicago, Ill.: Univ. of Chicago Press, 2003), Allan H. Meltzer, *A History of the Federal Reserve Volume II, Book One* (Chicago: University of Chicago Press, 2009), and Allan H. Meltzer, *A History of the Federal Reserve. Volume II, Book Two* (Chicago, Ill.: Univ. of Chicago Press, 2014) for a

either histories of individual institutions, or broader analyses by economists and journalists who have not focused on the institutional context of evolving banking and financial regulations.[64]

This dissertation builds on earlier histories and economic analyses to show how all the relevant federal and state institutions acted together with the banking industry to advance the narrative that the regulatory structure must be adjusted to accommodate the realities of a financialized and globalized financial system. The particular insight here is that the regulatory agencies' focus on New Deal laws rather than new market conditions shaped banking regulation in the U.S. along the unique path it took in the 1990s, which led to a universal banking regime without adequate safety and soundness regulations. Specifically, their collective preoccupation on Depression-era concerns for moral hazard and deposit insurance prevented them from considering new regulatory oversight measures appropriate for the actual new financial market conditions.

The Associational Synthesis

A recent scholarly trend in APD literature developed a different view of the interrelationship between the state, other civic and public institutions, and the American people. Ellis Hawley inaugurated the discussion about associational relationships and the possibility that state power projected through them might be more acceptable to Americans than direct government intervention. He focused on the relatively narrow

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history of the development of the functions of the Federal Reserve; and Joel Seligman, *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance* (New York: Aspen Publishers, 2003) for a legal insight into the history of the SEC.

[64] Christy Ford Chapin, "The Politics of Corporate Social Responsibility in American Health Care and Home Loans," *Business History Review* 90, no. 04 (2016): 647–70 is a notable exception. Although not about banking deregulation per se, this study provides a parallel analysis of commercial bankers' efforts to temper Congressional and regulatory action that would have amounted to federalizing the home mortgage system.

period between the national planning efforts of World War I and the National Industrial Recovery Administration early in the New Deal.[65]

Brian Balogh, who credits Hawley with the original concept but suggests the appeal of his arguments was potentially limited by the original narrowly defined time period, contends that the overall pattern developing within APD is an "associational synthesis." In his view, the historical relationships are not about small versus big, or liberal versus conservative, or even Republican versus Democrat. He cites Republican examples of expanding the state, such as Eisenhower expanding Social Security, or Nixon implementing cost of living allowance on federal transfer payments, as well as Democrats cutting taxes and reducing benefits. Balogh argues the focus should be on the ways in which Americans have used private and voluntary actions as well as either hidden or minor accretions of state power to achieve societal goals without undermining the essential American belief in individual freedom. In other words, Americans accept federal state solutions better if mediated through their local government, employer, non-profit organization, school, or church.[66]

In this tradition, several scholars have looked at the effect of law and regulations in creating and sustaining markets or establishing non-governmental intermediaries for

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[65] Ellis Hawley, *The New Deal and the Problem of Monopoly: A Study in Economic Ambivalence* (New York: Fordham University Press, 1995), 36-43.

[66] Balogh, *The Associational State,* 201-220, and 224 fn6; Christy F. Chapin, *Ensuring America's Health: The Public Creation of the Corporate Health Care System* (New York: Cambridge University Press, 2015); Julia F. Irwin, *Making the World Safe: The American Red Cross and A Nation's Humanitarian Awakening* (New York: Oxford University Press, 2013). Examples include administering New Deal agricultural programs via farm interest groups, leveraging tax expenditures for pension benefits, and corporate provided health care. Chapin documents the public–private model through the example of the application of a private insurance model structure to the Medicare program. Irwin focuses on the U.S. government providing disaster relief by payments to the Red Cross.

regulation.[67] Gerald Berk, for example, focused on Louis Brandeis and the Federal Trade Commission. In the end, he concluded that the government was able to manage competition by ceding oversight authority to professional and trade associations.[68]

A key contention of this dissertation is that the associational synthesis in APD is a meaningful paradigm for significant aspects of financial deregulation. That is, the American preference for constraining the role of the state even as it grew in power by leveraging intermediaries or associations may be seen in the evolution of financial deregulation. Jonathan Baskin and Paul Miranti, for example, argued that in addition to mandating public disclosure of specific information to facilitate market decisions, the Securities Acts of 1933 and 1934 also created a regulatory partnership between Congress, the Securities Exchange Commission, and professional financial trade groups.[69] But as this dissertation demonstrates, these same relationships became entrenched, limiting the extent of financial services reform in the 106th Congress. Instead, functional regulatory relationships were retained (e.g., the SEC over securities underwriting and state insurance commissioners over insurance underwriting) and market reforms necessary to accommodate new products that represented potential systemic risks were excluded.

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[67] Marc A. Eisner, "Markets in the Shadow of the State," in *Government and Markets: Toward a New Theory of Regulation,* eds. Edward Balleisen and David Moss (New York: Cambridge University Press, 2010), 512-537; and Cathie Jo Martin, "Sectional Parties, Divided Business," *Studies in American Political Development* 20, 2 (2006):160–161.

[68] Gerald Berk, *Louis D. Brandeis and the Making of Regulated Competition, 1900-1932* (New York: Cambridge University Press, 2009), 115-150.

[69] Baskin and Miranti, *A History of Corporate Finance*, 201-204. Also see Louis Galambos, *America at Middle Age: A New History of the United States in the Twentieth Century* (New York: McGraw-Hill, 1982), 29-35 who noted that dividing economic regulatory power between public and private groups was common in the United States.

In particular, we will see that the political demand by the securities and insurance industries that their regulatory agencies retain oversight roles had the practical effect of ensuring that the underlying regulations of the financial services industry remained unchanged after GLBA and the CFMA. This represented a missed opportunity to update the regulatory structure for new financial instruments such as OTC derivatives.

Another concern about retaining the same regulatory relationships among the financial services industries was the increased complexity of the regulatory environment. Indeed, it was unclear that the bank examiners, SEC, or state insurance commissioners were able to provide adequate oversight of their respective charges. Economist Daniel Tarullo highlighted that over the past 25 years, as deregulation affected the underlying safety and soundness regulatory framework for banking, capital adequacy requirements became the most important type of regulation designed to protect bank safety and soundness. This was reflected in the Basel I international agreements on adequacy of capital reserves standards that were issued in in 1988. However, in the U.S. there was a shift away from the prescriptive capital allocation standards of Basel I because of a "supervisory approach that increasingly relied on the sophistication and integrity of a bank's own risk management systems."[70] Indeed, the SEC explicitly authorized the major investment banks to use their internal models to determine their net capital reserve requirements.[71]

[70] Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation* (Washington, D.C.: Peterson Institute for International Economics, 2008), 15.

[71] James Kwak, "Cultural Capture and the Financial Crisis," in *Preventing Regulatory Capture: Special Interest Influence and How to Limit It,* eds. Daniel P. Carpenter and David A. Moss (New York, NY: Cambridge University Press, 2014), 71-98 discusses SEC Final Rule 69 Fed Reg. 34428.

From the perspective of the associational synthesis, this shift represented another example of regulators deferring to the expertise of the private sector. In other words, the regulators increasingly began to rely on the banks' own models to assess the riskiness of their asset portfolios and therefore the adequacy of their capital reserves![72] What has been less explicitly discussed in the literature, and will be explored in this dissertation, is the extent to which the American tendency to leverage private structures in public governance evolved in the 1990s into a free-market bias that allowed key regulators, especially the Federal Reserve, to misconstrue the risks to the safety and soundness of the banking system of new financial products, institutions, and markets such as over-the-counter derivatives. In other words, beyond market failure we must also consider governmental or regulatory failure.[73]

Policy Development

While this dissertation is intended as a history, not a public policy analysis, it will make use of concepts from the public policy field such as issue framing, interest groups, and policy analysis.[74] The initial public policy framework leveraged in this dissertation will be based on John Kingdon's three streams model, which argues that public policies

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[72] Lisa DeFerrari and David E. Palmer, "Supervision of Large Complex Banking Organizations," *Federal Reserve Bulletin* February (2001): 47–57.

[73] Edward Balleisen and David Moss, Introduction to *Government and Markets: Toward a New Theory of Regulation,* eds. Edward Balleisen and David Moss (New York: Cambridge University Press, 2010), 3-6.

[74] David L. Weimer and Aidan R. Vining, *Policy Analysis: Concepts and Practice,* (Boston: Longman, 2011, 1992); Eugene Bardach, *A Practical Guide for Policy Analysis: The Eightfold Path to More Effective Problem Solving,* (Washington D.C.: CQ Press, 2009); Martin Gilens, *Affluence and Influence: Economic Inequality and Political Power in America* (Princeton; New York: Princeton University Press and Russell Sage Foundation), 2012; Thomas E. Nelson, "Issue Framing," in *The Oxford Handbook of American Public Opinion and the Media,* eds. Robert Y. Shapiro and Lawrence R. Jacobs (New York: Oxford University Press, 2011), 189-203; and Deborah Stone, "Interests," in *Policy Paradox: The Art of Political Decision Making* (New York: Norton, 2012), 229-247.

are changed at the convergence of problems, policies, and politics. His classic concept is that policy windows, or opportunities for legislation to be enacted, are either recognized or are specifically brought about by political entrepreneurs. Other policymakers then take advantage of the window to advance their own agendas.[75]

For example, the banking industry, and increasing the financial regulatory community, advocated the repeal of Glass-Steagall in order to ensure U.S. banks were competitive in the new globalized financial markets. However, throughout the 1990s political opposition by the securities and insurance industries stymied repeal legislation. As a result, the banks used the support of the Federal Reserve Chairman and the Comptroller to slowly change regulatory interpretations of policies on affiliation among banking, securities, and insurance. When the policy window to repeal Glass-Steagall reopened in the 106th Congress, policy entrepreneurs sought to advance their own issues: for example, as with Congressman Leach to protect community banking; Senator Phil Gramm to weaken community reinvestment laws for small banks; and President Bill Clinton to advance a new agenda concerning financial privacy as an issue around which Congressional Democrats could rally. Even then, GLBA passed in 1999 only when the positions taken by various interest groups, political leaders, and regulatory bodies fell into alignment at the same time that private market conditions supported structural deregulation.

The concept of veto points dovetails nicely with Kingdon's approach. Veto point analysis has a distinguished pedigree in political philosophy that was summarized and

[75] John W. Kingdon, *Agendas, Alternatives, and Public Policies* (Glenview, IL: Longman, 2011, 1984), 15-20.

applied to the modern American context by George Tsebelis.[76] The basic argument is that to change the status quo certain institutional actors must agree to the change. The United States is often viewed as having a relatively high number of veto points based both on its constitutional structure, from its bicameral legislature, independent judiciary, and enumerated presidential powers, as well as its two-party system. This concept is important to understanding the politics of passing GLBA, because it is helpful to explain both the timing of the law's passing and the features that were included as well as excluded.

Thomas Hammond provides an insightful analysis of the interrelationships of bureaucratic autonomy and veto points. He acknowledges that, in a Weberian sense, the bureaucracy can often be an independent veto point. But he also argues that a bureaucracy can have more or less autonomy depending on the clarity and unity of intent among elected leaders. If the politicians are divided, then the bureaucracy has more opportunity to exercise autonomy. In the case of financial services modernization, this approach helps explain the regulatory efforts of the Federal Reserve and OCC in reinterpreting and expanding what was permitted by commercial banks in terms of underwriting securities or selling insurance. If Congress instead had chosen to act in the

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[76] George Tsebelis, *Veto Players: How Political Institutions Work* (Princeton, N.J: Princeton University Press, 2002), 67-91. See James Madison, "Federalist No. 62" in *The Federalist Papers*, ed. Richard B. Bernstein (New York: Arcturus Publishing, 2016) and Charles de Secondat Montesquieu, *The Spirit of Laws; Together with an English Translation of an Essay on Causes Affecting Minds and Characters (1736-1743)*, ed. D. W. Carruthers (Berkeley: University of California Press, 1977) for historical approaches. Also see Matthew D. McCubbins, Roger G. Noll, and Barry R. Weingast, "Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies," *Virginia Law Review* 75, no. 2 (1989): 431-82; Robert D. Cooter and Tom Ginsburg, "Comparative Judicial Discretion: An Empirical Test of Economic Models," *International Review of Law and Economics* 16, no. 3 (September 1, 1996): 295–313 for the interaction of the legislature, bureaucracy, and judiciary as veto points.

face of changing market conditions in banking, then the regulatory agencies would have been constrained by the new legislative paradigm. One important argument of this dissertation is that the financial institutions themselves, working either directly or through trade associations, had become powerful enough to influence both bureaucratic and Congressional veto points to ensure that any legislation that passed met their requirements.[77]

Paul Pierson complements such approaches to policy decisions with the consideration of policy development over time, arguing that a historical approach to public policy accounts for the fact that real social processes have temporal dimensions. An advantage of Pierson's approach is that it encourages the use of concepts necessary for temporal understanding such as path dependence, critical junctures, duration, timing, and unintended consequences that often receive insufficient attention in policy histories.[78]

Pierson argues these concepts are useful for a variety of reasons. He points out that current policy decisions are path dependent, or structurally influenced by past policy decisions. For example, in financial services modernization the functional oversight of the insurance industry was shaped by 19th century decisions that insurance was not interstate commerce and hence not subject to federal regulation. Furthermore, the origins

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[77] Thomas H. Hammond, "Veto Points, Policy Preferences, and Bureaucratic Autonomy in Democratic Systems," In *Politics, Policy, and Organizations: Frontiers in the Scientific Study of Bureaucracy*, eds. George A. Krause and Kenneth J. Meier (Ann Arbor: University of Michigan Press, 2003), 73-103.

[78] Paul Pierson, *Politics in Time: History, Institutions, and Social Analysis* (Princeton: Princeton University Press, 2004), 17-54. See Eric Patashnik, "After the Public Interest Prevails: The Political Sustain-ability of Policy Reform," *Governance* 16 (2003): 203–34; Martha Derthick, *Policymaking for Social Security* (Washington, D.C., 1979), 9; Evelyn Huber and John Stephens, *Development and Crisis of the Welfare State: Parties and Policies in Global Markets* (Chicago, 2001), 32 who all advocate a similar approach.

of many social processes are removed in time from their continuing effects. Consider that federal deposit insurance was perennially stymied by Congress until it appeared necessary to restore confidence in the banking system during the Great Depression. Yet having been implemented, it now remains unchallenged as the last major vestige of the New Deal banking reforms. Additionally, Pierson notes that sequencing, or the order of events or processes, sometimes can affect policy outcomes. Other processes are slow moving or developing over time, and may be misunderstood if examined as a single event. As a result, institutional outcomes are often better framed as policy development over time rather than as a policy choice at a particular snapshot in time, or functionally starting from current policies and working backwards to understand how they came about.[79]

This dissertation leverages the insight that the shaping of public policy is about more than a singular policy choice, but also about key policy developments that frame the moment of policy choice. In particular, it seeks to place the particular policy event of repealing one Depression-era law, Glass-Steagall, in a broader frame that includes both the renewal of the Commodity Exchange Act and a common set of themes that span both events.

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[79] Paul Pierson, "The Study of Policy Development," *Journal of Policy History*, no. 1 (2005): 34. See also Suzanne Mettler, "Bringing the State Back in to Civic Engagement: Policy Feedback Effects of the G.I. Bill for World War II Veterans," *American Political Science Review* 96 (2002): 367–80; Theda Skocpol, *Protecting Soldiers and Mothers: The Political Origins of Social Policy in the United States* (Cambridge, MA: Belknap Press of Harvard University Press, 1992); Jacob Hacker, *The Divided Welfare State: The Battle Over Public and Private Social Benefits In The United States* (New York: Cambridge University Press, 2002), 275-313; Alexander Keyssar, *The Right to Vote: The Contested History of Democracy in the United States* (New York: Basic Books, 2000), 107-116 for examples of the use of policy development to explain how early policy decisions affect long-term policy outcomes.

History of Capitalism and Financialization

Although APD provides a structure in which to conceptualize policy history it is also useful to turn to another literature, now termed "history of capitalism," to consider the particular policy issues associated with banking deregulation. In this literature, the deregulation of the financial sector that occurred in the United States during the 1980s and 1990s can be considered as part of the overall economic, social, and political trends that have been characterized as "financialization."[80] Our understanding of the factors leading to the passage of GLBA as part of the trend towards financialization is informed by consideration of neoliberalism and the changing ideological landscape for banking regulation; pluralism and the role of interest groups in advocating deregulation; as well as regulatory interpretations within the institutional structure of financial oversight.

Financialization and Neoliberalism

Influential historians, including Seth Rockman and Gerald Davis, highlight the importance of financialization as a process that reshapes the economy along the lines of savings, investment, and risk management.[81] Financialization itself is generally taken to refer to a broad-based transition in the economy from the production of goods to the providing of services, with an increasing reliance on financial services. According to Greta Krippner, financialization encompasses trends such as an increasing focus by corporations on shareholder value, an increase in financial activities such as securitization

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[80] Sven Beckert, et al, "Interchange: The History of Capitalism," *Journal of American History* 101, no. 2 (September 2014): 503–36. The history of capitalism generally includes concepts that were previously included in discussions of political economy and incorporates long-standing literature in various subfields such as business, labor, economic, and social history.

[81] Seth Rockman, "What Makes the History of Capitalism Newsworthy?" *Journal of the Early Republic,* 34 (2014): 439–466; Gerald F. Davis, *Managed by the Markets: How Finance Reshaped America* (New York: Oxford University Press, 2009), 235-255.

of debt and equity, and a greater emphasis on financial services over production.[82] That is to say, production of goods continues but is relatively less important to the extent that financialization takes hold. In this sense, it is a post-industrial phenomenon that began in the 1970s that extends beyond financial markets for equities or bonds.

A subset of the history of capitalism literature considers the changing economic and financial market conditions after the 1970s. In order to set the stage, the post-WWII combination of an international free trade regime, domestic Keynesian fiscal policy, highly regulated financial institutions, and high wages coincided with the economic era from 1947-1973. During this period inequality in wealth and income fell as economic growth soared, in what Judith Stein calls "the great compression." While Stein did not consider the New Deal era banking regulatory structure specifically, she among others attributes the success of the U.S. economy in this period to enlightened government oversight.[83]

Yet the economy stumbled badly in the 1970s. There is a substantial literature comparing the post-WWII period as a golden age of American power with economic policy failures of the 1970s. These scholarly works are interesting in part because of what they imply about the development of faith in a new market-based regulatory approach, sometimes termed "neoliberalism." Julia Ott suggests that neoliberalism includes elements such as a laissez faire approach to regulation, a focus on shareholder value as the aim of corporate and government policy, and preference for financial markets as the

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[82] Greta R. Krippner, *Capitalizing on Crisis: The Political Origins of the Rise of Finance* (Cambridge, Mass.; London: Harvard University Press, 2012), 27-57.

[83] Judith Stein, *Pivotal Decade: How the United States Traded Factories for Finance in the Seventies* (New Haven: Yale University Press, 2010), 1-22. Stein does not use the "financialization" terminology when discussing this phenomenon even though her factors would meet the definition.

optimal mechanism for allocating economic resources and risk. One particular aspect of the trend by which the neoliberal consensus supplanted the postwar policy regime, sometimes characterized as Keynesian, was the belief at the time that deregulation of financial markets should be preferred as a more effective, efficient, and actually less risky policy. This view of neoliberalism as not only supplanting faith in Keynesianism but also as a justification for shifting regulatory preferences in finance from government oversight to market discipline, had a significant impact on the evolution of banking deregulation in the face of specific innovations in financialization.[84]

Banking Deregulation: The Changing Ideological Consensus

According to Larry Schweikart, prior to the 1970s almost all scholars accepted the paradigm that commercial banks were quasi-public entities that markets alone could not adequately regulate.[85] He attributes this consensus to the seminal work by Bray Hammond, which served as an intellectual basis for the position that the government has

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[84] Julia C. Ott, *When Wall Street Met Main Street: The Quest for an Investor's Democracy* (Cambridge: Harvard University Press, 2011), 3. See also Alan Brinkley, *The End of Reform: New Deal Liberalism in Recession and War* (New York: Alfred A. Knopf, 1995); Michael E. McGerr, *A Fierce Discontent: The Rise and Fall of The Progressive Movement In America, 1870 – 1920* (New York: Oxford University Press, 2005); Allen J. Matusow, *Nixon's Economy: Booms, Busts, Dollars, and Votes* (Lawrence, KS: University Press of Kansas, 1998); and Benn Steil, *The Battle of Bretton Woods: John Maynard Keynes, Harry Dexter White, and the Making of a New World Order* (Princeton: Princeton University Press, 2013). Although labeled neoliberalism, this turn to the market by government and society might also be considered a return to classical liberalism after the New Deal reform liberalism that persisted in the post-World War Two period. Brinkley and McGerr offer related interpretations of liberal reforms in the progressive and New Deal eras. Steil and Matusow discuss the postwar financial regime, including the creation of the International Monetary Fund, the General Agreement on Tariffs and Trade, and World Bank respectively, as well as the use of the dollar, convertible to gold, as the international reserve currency.

[85] Larry Schweikart, "U.S. Commercial Banking: A Historiographical Survey," *The Business History Review* 65, no. 3 (Autumn 1991): 606–61. In this view money was assumed to have unique characteristics that prevented it from behaving like other commodities and commodity markets. Schweikart contends that even free market advocates Friedman and Schwartz accepted this premise.

to regulate banking, and the more centralized the better. Hammond effectively set the tone of the academic and policy for a decade.[86] However, the issues raised above regarding financialization, securitization, and globalization also led to a richer academic debate about the role of regulation itself affecting the market. Simultaneously, the study of financial regulation became the subject of additional fields, examining questions such as the significance of public psychology as an element of banking panics, or the sociology of bankers and banking.[87] As a result, since the 1970s a new generation of banking historians and economists challenged the quasi-public bank regulation analytical framework.

Charles Calomiris was an intellectual leader in revising the historical understanding of banking regulation. In particular, he showed how deregulation in the 1980s and 1990s redefined the unique characteristics of American banking, which previously included a fragmented geographical structure, restricted scale for individual banks, and limited competition, as well as strict limits on the kinds of products and services commercial banks could offer. Calomiris' intent was to leverage a historical analysis to explain the political constituencies for and against deregulation, the political process they must navigate in order to affect bank regulation, and the likely impact of deregulation on both bank performance and stability.[88]

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[86] Bray Hammond, *Banks and Politics in America from the Revolution to the Civil War* (Princeton: Princeton University Press, 1957/1991), 718-739.

[87] Karen Ho, *Liquidated: An Ethnography of Wall Street* (Durham: Duke University Press, 2009), 122-169 undertakes an ethnographic investigation of Wall Street investment bankers, concluding that their internal culture of risk taking and sense of entitlement carry forward to the markets that they make, and contributed to the shift in corporate focus to shareholder value.

[88] Charles W. Calomiris, *U.S. Bank Deregulation in Historical Perspective* (New York: Cambridge University Press, 2006), 1-92.

This is not to say Calomiris is the best objective reference about banking regulation per se. His interests are decidedly political and economic, and he approaches his history from an economist's point of view. Others provide more complete surveys of changes in law, regulation and court rulings.[89] However, since Calomiris' arguments have been influential, they are worth noting in more depth.

Writing just after GLBA allowed banks to undertake insurance activities and repealed the separation between commercial and investment banking, Calomiris argued that banking deregulation was the culmination of a long series of deregulatory steps. While the accumulated effects of deregulation resulted in dramatic financial innovations, he suggested that by the 1990s the deregulation process itself was uncontroversial, in part because economic and financial academic research consistently undercut the premise of the regulatory regime for the U.S. banking system.[90]

One key finding by Calomiris himself challenged a crucial premise of the New Deal banking regulatory framework and was directly contrary to the view of contemporary economists and critics of neoliberalism who attributed the economic stability of the postwar period times to the power of macroeconomic policies and the governmental safety net. To Calomiris it appeared instead that the post WWII stability simply reflected an unusually long period of low commodity prices and minimal asset price volatility. The implications were staggering. If correct, this meant that the New

[89] Kenneth Spong, *Banking Regulation,* 63-252; Macey, Miller, and Carnell, *Banking Law and Regulation*, 119-427; William Haraf, "Principle Policy Conclusions and Recommendations of the Financial Services Regulation Project," in *Restructuring Banking & Financial Services in America*, eds. William S. Haraf and Rose Marie Kushmeider (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1988), 431-439.

[90] Calomiris, *U.S. Bank Deregulation,* xi-xiii.

Deal banking regulatory structure went untested until the 1970s, when shocks to commodity prices, exchange rates, and high inflation overwhelmed the financial safety net.[91]

Other scholarly analyses undermined the original basis of the Glass-Steagall Act. The most important of these was George Benston's demonstration that the conventional wisdom for the enactment of Glass-Steagall was not well supported.[92] By combining a review of the legislative record with empirical data Benston shows there was no evidence that commercial banks with securities affiliates had higher rates of failure than other banks. Benston's view was not universal. For example, Krus, following an institutionalist approach, argues that Glass-Steagall was the logical regime based on the balance among financial intermediaries, government regulators, and Congress.[93] That said, the net effect of the scholarly debate in the 1990s was to undermine the need for strict adherence to the New Deal banking regime.

Research questioning the premise of the Depression-era laws was buttressed by conducting international comparisons among banking systems. Barth, Bumbaugh, and Wilcox challenged the need for a separation among commercial and investment banks, as well as insurance companies, by demonstrating that other nations allowed commercial and investment banking to be combined, sometimes termed universal or broad banking.[94]

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[91] Charles Calomiris, *The Postmodern Bank Safety Net: Lessons from Developed and Developing Economies* (Washington, D.C: AEI Press, 1997), 37.

[92] George J. Benston, *The Separation of Commercial and Investment Banking,*1-32. See also Larry Neal and Eugene N. White, "The Glass–Steagall Act in Historical Perspective," *The Quarterly Review of Economics and Finance* 52, no. 2 (May 2012): 104–13.

[93] Jill S. Krus, "Saving the Financial System: Financial Reform in the 1930s." Ph.D., University of Notre Dame, 1994.

[94] Barth, Bumbaugh, and Wilcox, "Broad Banking," 192.

There were other broad international comparisons as well as country specific studies. Joseph Asher for example argued that there was convincing evidence overseas in Germany and Switzerland that the separation of commercial and investment bank functions was unnecessary.[95]

Another trend in the academic literature supporting the move towards banking deregulation was a series of contemporary economic and public policy studies that drove an evolving consensus among economists that government regulation could actually be harmful to the regulated industry. For example, Martha Derthick and Paul Quirk conducted an influential analysis of three case studies in deregulation. They concluded that the long-term rationale for regulatory regimes, as a way to guarantee that certain industries such as transportation, communications, and banking served the public good and prevent monopoly pricing, was flawed. Interestingly, they argue that experts in public policy, administrative law, and political science, had this view of regulation for some time, but it was only in the 1970s that regulation per se came under attack by economists as well.[96]

From the perspective of banking, various economic analyses also made the related argument that deregulation was beneficial to the industry. For example, Jason Karceski

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[95] Joseph Asher, "Banking Without Glass-Steagall? Look Overseas," *ABA Banking Journal* (May 1995) 42–47; Charles W. Calomiris and Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit* (Princeton, New Jersey: Princeton University Press, 2014.); Richard S. Grossman, *Unsettled Account: The Evolution of Banking in the Industrialized World since 1800* (Princeton: Princeton University Press, 2010).

[96] Martha Derthick and Paul J. Quirk, *The Politics of Deregulation* (Washington, D.C: Brookings Institution, 1985), 8-14. Note that banking is not one of the three case studies offered. However, the authors cite it as another appropriate case that they could have included based on the history of the Depository Institutions Deregulation and Monetary Control Act of 1980.

and Calomiris concluded in a major study on banking efficiency that both banks and their customers had benefited from deregulation, increased competition, and improvements in bank structures and services. In other words, data appeared to support the contention that, to the extent that it encourages competition and consolidation, deregulation in banking raises productivity and reduces risk. [97]

Finally, other scholarly analyses found deregulation to be a function of cultural capture. Indeed, Daniel Carpenter and David Moss argued that cultural capture is often the most significant contributor to deregulation because a single viewpoint, typically that of the formerly regulated industry, becomes conventional wisdom among the regulators as well.[98]

Interest Groups, Influence, and Deregulation

Beyond the changing ideological consensus, Calomiris also argued from a pluralist perspective that banking deregulation is actually best explained by the degree of concentration among interest groups, their ability to lobby Congress and regulatory agencies effectively, implications for the relative power of regulatory agencies, and the extent to which political entrepreneurs could frame regulatory changes.[99] Regarding the power of interest groups, the history of banking regulation is consistent with a general

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[97] Charles W. Calomiris and Jason Karceski, *Is the Bank Merger Wave of the 1990s Efficient? Lessons from Nine Case Studies* (Washington, D.C: AEI Press, 1998), 4-6.

[98] Daniel P. Carpenter and David D. Moss, *Preventing Regulatory Capture: Special Interest Influence and How to Limit It* (New York, NY: Cambridge University Press, 2014), 20. See also Michael Pertschuk, *Revolt against Regulation: The Rise and Pause of the Consumer Movement* (University of California Press, 1982), 5-45 for an alternative view, which claims deregulation was a reaction to the excesses of the consumer protection movement.

[99] Calomiris, *U.S. Bank Deregulation*, 1-93; Kingdon, *Agendas, Alternatives, and Public Policies,* 18-20. Calomiris' focus on political entrepreneurs is very much in the tradition of Kingdon's three streams model.

premise of public policy; that is, a concentrated minority interest can be more successful in the political process than diluted majorities.[100] This point may be broadened to include financial services modernization more generally. That is, as regards advocacy for a legislative repeal of Glass-Steagall, the banking, securities, and insurance industries all came to advocate for legislative action once regulatory actions alone were no longer sufficient to keep them competitive.

Calomiris contended that in the case of recent banking deregulation, the administrative state and Congress both were responding to pressure from the commercial banks, whose profits continued to erode under the constraints of New Deal banking regulations that had failed to keep up with modern technologies and factors exogenous to the banking industry.[101] According to Robert Barnett, these external factors included competitive pressure from foreign banks, both domestically and internationally, as well as increasing competition from mutual funds, pension funds, commercial paper markets, and nonbank financial intermediaries like finance companies and credit unions.[102] As Calomiris put it, these competitive pressures increasingly offered U.S. bank regulators a choice between "regulating less and having less to regulate."[103]

Economist Simon Johnson and his financial journalist co-author James Kwak broaden the focus on the influence of the financial industry in deregulating banking. In their view, the 1990s marked a point at which government decided to stop resisting the

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[100] James Q. Wilson, "The Politics of Regulation," in *The Politics of Regulation,* ed. James Q. Wilson (New York: Basic Books, 1980), pp. 357-390.

[101] Calomiris, *U.S. Bank Deregulation,* xiii-xiv; Macey, Miller, and Carnell, *Banking Law and Regulation*, 77-79. See also Appendix 3.

[102] Robert Barnett, "A Brief Note on Why Glass-Steagall Was Repealed," *Our Perspectives: Commentary on the Economy and Regulatory Policies Affecting Financial Companies* (April 2013): 1-7.

[103] Calomiris, *U.S. Bank Deregulation,* xv.

desires of large commercial banks to become national full service, or universal, banks. Equally important, from the standpoint of safety and soundness, the government made no effort to regulate new financial innovations such as OTC derivatives or the developing subprime mortgage market. This was in many ways a conscious decision as many leading politicians, whether convinced by lobbyists or by the economic boom times of the 1990s, chose to rely on "self-regulation" of financial markets, or the idea that market forces could prevent fraud and excessive risk, rather than prescriptive government regulation.[104]

Beyond the interest of commercial banks in deregulation generally, bankers also had clear interests in the specific repeal of Glass-Steagall. Although there are many corporate histories about individual banks and bankers, those concerning Citigroup are particularly relevant given the role played in the repeal of Glass-Steagall by Citibank and its eventual successor Citigroup.[105] For example, several books portrayed the merger of Citibank and the insurance and securities firm Travelers into Citigroup as one of the final forcing functions to get Congress to rationalize the ad hoc regulatory decisions and judicial precedents that had slowly been undermining the Glass-Steagall regulatory framework throughout the 1990s.[106]

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[104] Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (New York: Pantheon, 2010), 89-90. See Stephen S. Cohen and J. Bradford DeLong, *Concrete Economics: The Hamilton Approach to Economic Growth and Policy* (Boston: Harvard Business Review Press, 2016), 165 who contend that in the 1990s it became the policy of the government to dismantle the financial regulatory framework in order to allow the markets to self-regulate.

[105] Moira Johnston, *Roller Coaster: The Bank of America and the Future of American Banking* (New York: Ticknor & Fields, 1990); Ron Chernow, *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance* (New York: Grove Press, 2010) represent two of many similar histories of banks and individual bankers aside from Citibank and those who led it.

[106] Monica Langley, *Tearing Down the Walls: How Sandy Weill Fought His Way to the Top of the Financial World-- and Then Nearly Lost It All* (New York: Simon &

Other contemporary articles discussed the value of a legislative repeal of Glass-Steagall to the financial services industries more broadly. For example, banks were largely satisfied with the results of their regulatory and judicial campaign until insurance companies and large retailers began to leverage unitary thrift holding companies to establish effective competition to the large commercial banks, which caused banks to seek common ground with the insurers.[107] Similarly, Lissa Broome and Jerry Markham provided a retrospective analysis of the state of insurance regulation before and after GLBA, highlighting the industry's need to prevent commercial banks from developing a competitive advantage over local insurance agencies by ensuring they had the same licensing requirements.[108] Finally, Edward Eisert discussed the desire by the securities industry to constrain the ability of banks to underwrite and sell securities under banking regulation rather than under the common rules established by the SEC.[109]

The Role of Institutional Structures in Financial Deregulation

The regulatory state had its own interests in deregulation of the banking industry. Martin Wolfson provides an institutional perspective on why the shift from the Keynesian to neoliberal paradigm mattered from the perspective of banking deregulation. He agrees

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Schuster, 2003); Amey Stone and Mike Brewster, *King of Capital: Sandy Weill and the Making of Citigroup* (New York: Wiley, 2002). These books carry on the tradition of books about banks and bankers such as Harold van B. Cleveland and Thomas F. Huertas, *Citibank, 1812-1970* (Cambridge, Mass: Harvard University Press, 1985); Phillip Zweig, *Wriston: Walter Wriston, Citibank and the Rise and Fall of American Financial Supremacy* (New York: Crown Publishers, 1995), 236-37, 383.

[107] Jonathan R. Macey, "The Business of Banking: Before and After Gramm-Leach-Bliley," *Journal of Corporation Law* 25, no. 4 (2000): 691–719. Macey also concluded that the most likely explanation for why GLBA passed was the self-interest of the industry players, but argued that did not mean it was necessarily bad public policy.

[108] Broome and Markham, "Before and After," 723-64.

[109] Edward G. Eisert, "Overview of Financial Modernization Legislation from a Securities Regulatory Perspective: Broker-Dealer and Investment Management Activities," *Banking & Financial Services Policy Report* 19, no. 9 (May 2000): 5.

with Ott and Stein that by the late 1970s the New Deal economic structure supporting postwar financial stability, which encompassed regulatory limits to competition and federal deposit insurance, began breaking down. In particular, Wolfson is clear that increased government and private debt levels, stagflation, and the resulting erosion of the barriers to competition that had protected the traditional financial intermediaries, such as banks and thrifts, were all contributing factors. However, his particular insight is that the regulatory institutions began to see their interests aligned with deregulation of the financial industry rather than in preserving the New Deal era laws.[110]

Another perspective is to consider the dynamic roles the regulatory agencies assigned themselves as actors over time. Streek and Thalen provide a framework to discuss such long-term institutional change. This is useful for the present inquiry because specific aspects of the policy discussion come across as potentially driven by bureaucratic turf battles. For example, the Federal Reserve Board and the Office of the Comptroller of the Currency delayed any possible legislative repeal of Glass-Steagall until they resolved their differences over the appropriate oversight structure. Or, in another example, the Commodity Futures Trading Commission (CFTC) and the SEC were clearly at odds, especially during Chairwoman Brooksley Born's tenure at the CFTC, over the authority under the Commodity Exchange Act to regulate OTC derivatives or not.[111]

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[110] Wolfson, "An Institutional Theory of Financial Crises,"184-185. See also Haraf and Kushmeider, "Restructuring Financial Markets," 1-26.

[111] Wolfgang Streeck and Kathleen Thelen, "Introduction: Institutional Changes in Advanced Political Economies," in *Beyond Continuity* (New York: Oxford University Press, 2005): 1-24 suggest five potential modes: 1) displacement by another institution; 2) layering, in which one institution is subsumed; 3) drift; 4) conversion, or repurposing through political action; and 5) exhaustion. It is possible to be overly precise with the categories, but general framework is helpful to consider institutional transformation.

Yet a third perspective from the regulatory agencies was their leadership's evolving view of what steps were necessary to discharge their function. For example, Phillip Wallach argued that the financial regulators began to consider a strict reading of the law as unnecessary to achieve their agency mission of safety and soundness for commercial banks, and began to make administratively and regulatory decisions to accommodate the dynamic economic pressures on the banking industry. While Congress continued to resist, courts began to allow the evolving regulatory interpretations. The passage of GLBA then represented a normal evolutionary path in which Congress reasserted its authority over the regulatory state.[112]

Implications for New Financial Markets, Institutions, and Products

As a result of a changing ideological consensus, the perceived interests of the financial services industries, and the conclusions of the regulatory agencies, in the 1990s the concept of financial services modernization began to be equated variously with both deregulation and the repeal of Glass Steagall. Indeed, several good summary articles were written from the perspective of financial services industries that placed Glass-Steagall repeal squarely in the broader trend of deregulation in the U.S. from the 1970s.[113] Even legal analyses of current regulations made the case that GLBA was necessary because the evolved financial services regulatory structure in the late 1990s imposed costs and

[112] Philip A. Wallach, "Competing Institutional Perspectives in the Life of Glass–Steagall," *Studies in American Political Development* 28, no. 01 (April 2014): 26–48. See also Jerry Mashaw, "Norms, Practices, and the Paradox of Deference: A Preliminary Inquiry into Statutory Interpretation," *Administrative Law Review* 57 (2005): 501–552; R. Shep Melnick, *Regulation and the Courts: The Case of the Clean Air Act* (Washington, DC: Brookings Institution Press, 1983); and Martha Derthick, *Policymaking for Social Security* (Washington, DC: Brookings Institution Press, 1979) for further discussions of deregulation through bureaucratic and judicial interpretation.

[113] Hendrickson, "Glass-Steagall Reform", 849–79; Barth, Bumbaugh, and Wilcox, "Broad Banking," 191-204.

inefficiencies that impeded productivity, competitiveness, innovation, and better capital resource allocation.[114]

While stricter government regulation might once have been necessary to address natural financial market failures, the clear implication was that by the 1990s public policy goals could be met by deregulation and reliance on market discipline. The impact of this new consensus was felt well beyond the current financial services industries and their products. Specifically, the repeal of Glass-Steagall raised an important nuance in the evolution of banking reform in the 1990s. Even if the proposition that dynamic market conditions forced a reevaluation of the separation of commercial and investment banking is accepted at face value, why did other changes such as the evolution of OTC derivatives not prompt consideration of regulations for those new markets? That is, just because some older forms of regulation were made obsolete did not mean that it was appropriate to have no regulations for financial markets.[115]

Wolfson's argument that the perspectives of the financial institutions themselves must be considered is a start. This dissertation builds on that insight and argues that the shared perspectives of the financial institutions, notably the largest commercial banks, and federal regulators shaped the nature of the deregulation itself. In particular, New Deal restrictions on banking were removed, but because both the industry and regulatory agencies desired the regulatory relationships to remain the same, and Congress agreed as a compromise in order to pass GLBA, very little of the underlying regulatory structure

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[114] American Bar Association, "Project: Regulatory Reform: A Survey of the Impact of Reregulation and Deregulation on Selected Industries and Sectors: Dismantling of the Glass-Steagall Act," *Administrative Law Review* 47, no. 4 (1995): 445-568.

[115] Krippner, *Capitalizing on Crisis*, 27-57. Recall that securitization, combined with the development of OTC derivative markets, became the underpinning of swaps, a new class of financial derivatives developed during the 1990s.

was actually changed as a result. The problem with this outcome was that the status quo regulatory structures were inadequate for certain new markets and products.[116]

David Kotz noted that some new financial innovations, notably derivatives, were subject to little or no regulation to begin with. He argues that, unlike the long-term relationships and knowledge of the borrower encouraged by traditional banking, transactions within the shadow banking system emphasize a short term and hands-off outlook focused on fee generation and trading profit rather than sound and profitable lending.[117] This provided a strong incentive to financial institutions to avoid market oversight of transactions in derivatives. For example, Funk and Hirschman focus narrowly on derivatives based on interest rate and foreign exchange swaps to demonstrate that banks and broker dealers were able to evade effective regulation on derivatives because they did not fit within the traditional regulatory structure.[118]

Although close, this argument misses the mark. As we will see, what very experienced regulators such as SEC Chairman Arthur Levitt and Federal Reserve Chairman Alan Greenspan actually argued was that there was already oversight of the OTC market and other institutions such as hedge funds. That oversight was provided via

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[116] Wolfson, "An Institutional Theory of Financial Crises," 182-183.

[117] David M. Kotz, "Changes in the Postwar Global Economy and the Roots of the Financial Crisis" in *The Handbook of the Political Economy of Financial Crises,* eds. Martin H. Wolfson and Gerald A. Epstein (New York, NY: Oxford University Press, 2013), 405-406. Kotz suggests that this outlook contributed to the securitization phenomenon, with its focus on shareholder value, while in parallel the liberalization of capital flows and rollback of capital controls inherent in globalization raised the risk of global contagion. Hence, the financialization of the economy, which encompasses each of these factors, meant that the replacement of the postwar system of financial regulation with the neoliberal system made increasing financial turmoil and financial crisis more likely

[118] R. J. Funk and D. Hirschman, "Derivatives and Deregulation: Financial Innovation and the Demise of Glass-Steagall," *Administrative Science Quarterly* 59, no. 4 (December 1, 2014): 669–704.

controls over the financial institutions that interacted with these new institutions and products, such as when banks placed OTC derivatives contracts with counterparties such as hedge funds. In the view of Greenspan, Levitt and others, oversight of the way traditional institutions used new products such as derivatives was sufficient because the institutions themselves were constrained by market performance. To their way of thinking, any evasion as described by Funk and Hirschman would be corrected by the counterparties to the derivatives contract. Unfortunately, this nod to the neoliberal ideological consensus proved to be an erroneous misconception.

Specifically, to the extent banking supervision or SEC regulation was effective at the institutional level, it still only provided oversight of individual transactions and not of the derivatives market as a whole. It was a short step from the creation and sale of securitized financial instruments to the eventual creation and use of derivative instruments to mitigate the risk of discrete securitized transactions.[119] But this conditioned the view of regulators towards derivatives, in that they were considered as instruments to mitigate the risk of individual transactions. What this dissertation contributes to the discussion, however, is the proposition that both the financial services industry and regulators missed an important point. That is, the use of derivatives to

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[119] Marc Lavoie, "Financialization, Neo-liberalism, and Securitization," *Journal of Post Keynesian Economics 35,* 2 (2012): 215–233; Davis, *Managed by the Markets, 60-102.* See also Lizabeth Cohen, *A Consumers' Republic: The Politics of Mass Consumption in Postwar America* (New York: Vintage Books, 2004), 112-165; Louis Hyman, *Debtor Nation: The History of America in Red Ink* (Princeton: Princeton University Press, 2011), 220-280; and Louis Hyman, *Borrow: The American Way of Debt. How Personal Credit Created the Middle Class and Almost Bankrupted the Nation* (New York: Vintage Books, 2012), 230-247 for a discussion of the evolution of mass consumption and securitization of debt as two phenomena related to financialization that occurred in parallel over this same period.

mitigate the risk of specific transactions could create a systemic risk if the information asymmetries in the private markets were not addressed by effective regulation.

Literature Review: Conclusion

The literature about banking deregulation and the repeal of Glass-Steagall is extensive. However, our understanding of the history of financial services modernization in general, and in particular the dismantling of the New Deal bank regulatory framework, is enriched significantly when placed in the context of both APD and new interpretations in the history of capitalism. Indeed, it is in combining these approaches that a gap in the current literature emerges that is addressed by this dissertation.

As this review demonstrates, political and economic historiographical approaches can both successfully recount the interplay of policies, politics and key players that resulted in Glass-Steagall finally being repealed in 1999. Yet these two literatures are complementary. While APD provides a construct for both policy decisions and policy developments in financial modernization, it is the scholarly work in history of capitalism that serves as a backdrop for the changing ideological consensus among the financial services industry, regulatory state, Congress, and academia. Similarly, the pluralism of the evolving efforts by financial institutions and their interest groups to influence the outcome of banking deregulation is representative of the organizational synthesis. Moreover, the role of the state is visible in the proactive roles played by the regulatory agencies as institutional structures. Finally, the associational and self-regulatory biases of financial regulation illuminate the implications for new financial markets and products.

Considering the two literatures together, several key themes identified in the introduction emerge from the background. The fractured American policymaking process ensured that repeal of Glass-Steagall could not occur without a change in the ideological consensus. Institutional and corporate self-interests, played out in pluralism through the lobbying of interest groups, forced compromises that limited financial modernization to a narrow repeal rather than broad reform. Similarly, associational tendencies towards self-regulation contributed to a preservation of the underlying functional regulatory structure, which limited the impact of deregulation. In parallel, the institutional structures of the state developed a strong free market bias that, coupled with the secular trend towards financialization, inhibited true reform. Finally, these corporate and state regulatory interests were reinforced by a focus on protecting Depression-era financial constructs such as deposit insurance that hindered innovative solutions to regulating new institutions, markets, and products.

Building on the literature of APD and history of capitalism, the fundamental insight of this dissertation is that, while restrictions on the affiliation of commercial banks with insurance and securities firms were repealed, the underlying regulatory relationships were deliberately retained. As a result, few if any regulations were removed and certain necessary regulatory reforms were omitted or overlooked, including safety and soundness regulations to incorporate governmental oversight over dynamic new financial institutions and markets such as OTC derivatives.

Chapter 2: Setting the Stage for Gramm Leach Bliley

Scholars generally characterize the Gramm Leach Bliley Act (GLBA) as an important instance of banking deregulation because it overturned the Depression-era Glass-Steagall framework. Although GLBA repealed the Glass-Steagall portions of the Banking Act of 1933 and Bank Holding Company Act of 1956, the extent of banking deregulation was actually less significant than is generally understood because much of Glass-Steagall effectively had been repealed by regulatory and judicial actions in the two decades preceding GLBA's passage. Understanding how this process unfolded helps explain how lawmakers produced in GLBA a rather modest deregulatory measure while neglecting a crucial opportunity to include safety and soundness provisions that the financial market needed for stability. This chapter provides the necessary background to explain the regulatory and judicial campaign by large commercial banks to neutralize Glass-Steagall.

The unique American Depression-era financial regulatory structure began to fail in the 1960s and 1970s. Despite this long period of decline policymakers appeared to lack sufficient will to consider an end-to-end reform of the U.S. banking regulatory structure, even during the 1980s banking crisis. Instead, Congress responded with a piecemeal series of laws in the 1980s and early 1990s that eliminated aspects of the New Deal banking structure, beginning with interest rate and geographic restrictions. Once the crisis was resolved, Congress was reluctant to repeal the venerable Glass-Steagall Act that had so long characterized American banking. This lack of legislative action left commercial bankers and sympathetic federal regulators in the Federal Reserve, Office of the

Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC) to progressively undermine Glass-Steagall through the administrative regulatory process.

Several factors convinced the regulatory community to support the commercial bankers. First, there was an evolving ideological consensus that led to a preference for free markets and a bias toward industry self-regulation among many officials in the regulatory state. As this so-called neoliberal consensus slowly replaced Keynesianism as a governing philosophy, banking regulators increasingly supported the deregulatory trend sweeping the U.S. This was apparent in the regulatory decisions made by successive Comptrollers of the Currency, from William B. Camp in the late 1960s to C.T. Conover and Robert Clark in the 1980s, FDIC Chairmen such as Franke Wille, as well as Chairmen of the Federal Reserve, from Arthur F. Burns in the 1970s to Paul Volcker in the 1980s. By the 1990s, officials in the Federal Reserve, notably Chairman Alan Greenspan, and the OCC led by Comptroller Eugene Ludwig, concluded that the Depression-era policy separating commercial banks from the securities and insurance industries was no longer tenable if the U.S. banking sector was to remain competitive.[120]

The declining support for Glass-Steagall was not simply a matter of the leaders of the regulatory state becoming convinced by the economic theories of neoliberalism. A second defining factor was a fundamental shift in market forces for the U.S. financial sector. Recall that through Glass-Steagall provisions, Congress intentionally created an inefficient system, relative to the universal banking systems common in other

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[120] Comptroller Decision 12 C.F.R. § 7.7100 of 1971; *Securities Industry Assn. v. Board of Governors*, FRS, 468 US 137 - Supreme Court 1984; *Northeast Bancorp, Inc. v. Board of Governors*, FRS, 472 US 159 - Supreme Court 1985; *Inv. Co. Institute v. Conover*, 790 F. 2d 925 - Court of Appeals, Dist. of Columbia Circuit 1986; *Clarke v. Securities Indus. Ass'n,* 479 U.S. 388, 107 S.Ct. 750, 759, 93 L.Ed.2d 757 (1987).

industrialized democracies, in order to safeguard the banking system. The U.S. financial services sector could tolerate this structural inefficiency only until the economy faltered in the late 1960s. Thereafter, U.S. commercial banking was subjected to competition from foreign banks, domestic thrifts, nonbank financial institutions, and even the insurance and securities industries. This competition was exacerbated by advances in technology that enabled new financial products and services that blurred the distinction among bank, securities, and insurance products. During the 1990s, it became clear to leaders of all three financial services industries, their lobbyists, key regulators, and legislators that the Glass-Steagall framework was no longer viable. In other words, evolving economic and market conditions, competitive pressures, and technological advancements intersected with changing ideology to drive regulatory outcomes.[121]

The financial industry adapted its approach to deregulation in the face of both market factors forcing change and an evolving ideological consensus. As Alan Greenspan remarked, "Public policy should be concerned with the decline in the importance of banking…the issues are too important for the future growth of our economy and the welfare of our citizens." In order to enhance their competitiveness, commercial bankers elected to try to break free from the strictly defined roles appointed them by the New Deal regulatory framework. Even small bankers, who worried about encroachment by larger banks if geographic restrictions were lifted, sought the repeal of Glass-Steagall in order to improve their ability to deliver financial services to their customers. Overall, the

[121] "Banking Issues," *Congressional Digest* 71, no. 1 (January 1992): 7; Markham, "Banking Regulation," 253-257.

general crisis in banking made clear that regulatory changes were a necessity for commercial banking to regain its competitive footing.[122]

One consequence of the fact that bankers, broker-dealers, and insurers all sought market advantage in terms of the Depression-era regulatory structure was that the on-going debates occurred in that context rather than looking beyond it for new approaches. This tendency to focus on modifying Depression-era laws was reinforced by the regulators themselves, who naturally had a vested interest in the jurisdiction and role their agencies would have in any new regulatory scheme. The net effect was to encourage piecemeal rather than comprehensive reform. As a result, the campaign to repeal Glass-Steagall became part of a longer-term series of campaigns undertaken by commercial banks, including efforts to remove interest rate constraints during the banking crisis of the 1980s, and then eliminate branching and interstate banking restrictions in the early 1990s. In other words, both the regulatory and legislative efforts to repeal Glass-Steagall followed a familiar pattern that was focused backwards on New Deal laws governing the financial sector. This bias towards the Depression-era regulatory structure had an important impact on the eventual shape of GLBA, as bankers and policymakers were unable to reach a comprehensive reform approach that accounted for new products and institutions never envisioned during the New Deal.

As it turned out, the decentralized policy process in the U.S. delayed efforts to repeal Glass-Steagall through legislation. Since legislative repeal became a longer-term

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[122] Kenneth H. Bacon, "The End of Banking as We Know It – Losing Ground: Banks' Declining Role in Economy Worries Fed, May Hurt Firms," *Wall Street Journal*, July 9, 1993, A1; Steven Davidson, "Insurance Strategies for Banks," *America's Community Banker* 7, no. 7 (July 1998): 38.

prospect, commercial bankers focused first on a deliberate campaign to undermine the separation of banking from securities and insurance through piecemeal regulatory and judicial actions.

The success of the large commercial banks in these regulatory and judicial campaigns put the securities and insurance industries on the defensive. However, the insurance industry eventually discovered the unitary thrift loophole to be an effective counter to the encroachment by bankers. That is, by obtaining a charter for a single thrift institution from the Office of Thrift Supervision (OTS), insurance companies could circumvent Glass-Steagall restrictions to combine insurance and banking. As a result, commercial banks suddenly faced the possibility of competing against large well-capitalized universal banks that operated outside the commercial banking sector.

In many ways, the point-counterpoint of regulatory and judicial battles eventually made a legislative solution more acceptable to all sides. Investment bankers and insurers sought to ensure the commercial banks had to compete under a common ruleset, and they saw the unitary thrift loophole as leverage to achieve that goal. Bankers were interested in codifying gains from the regulatory battles and in circumscribing the use of unitary thrifts. Over this same period, the respective regulatory policies and agencies increasingly aligned with the interests of their governed industries. Finally, even legislators became more open to a repeal of Glass-Steagall in order to regain the initiative from the regulatory agencies as they observed the impact of regulatory repeal.

Ironically, the very success of the regulatory campaign undermined the transformational impact of GLBA when it was passed. Not only was much of the deregulatory impact already reflected in the administrative changes that were upheld in court, but the ability of the banking, securities, and insurance industries to counter each other in Congress forced the legislative campaign to a narrow focus on repealing Glass-Steagall. Additionally, the long and incremental battle to repeal Glass-Steagall kept the financial services industries, their trade associations, and policymakers focused on the Depression-era policy framework, which undermined the possibility of a new comprehensive regulatory structure. Finally, the focus on less regulation rather than better regulation blinded policy-makers to the necessity of ensuring safety and soundness in the emerging combined financial marketplace.

Factors Driving the Banking Deregulation Trend

As discussed, by the 1970s commercial banks faced increased competition from across the financial services industries as well as international financial institutions such as universal banks. In response, banking leaders sought relief from the Depression-era regulatory framework through a combination of regulatory, judicial, and legislative actions. However, the interim failure of the legislative efforts and the contrasting success of the regulatory and judicial campaigns to undermine Glass-Steagall are best understood as the interplay of several necessary but not sufficient conditions.

Congressional Support of the New Deal Framework

This section is primarily focused on institutional support for the New Deal banking regulatory structure.[123] Although the frameworks for banking as well as the broader financial industry were both consolidated in the 1930s, it was the commercial banking

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[123] See Appendix 5. A general list of the relevant New Deal legislation should include the Federal Home Loan Bank Act of 1932, the Securities Act of 1933, the Banking Act of 1933 (Glass-Steagall Act), the National Housing Act of 1934, the Securities Exchange Act of 1934, the Banking Act of 1935, and the Commodity Exchange Act of 1936

and thrift industries that faced the economic and market pressures that rendered their regulatory structures untenable over time. Yet, while bankers periodically sought regulatory relief, Congress remained committed to the New Deal banking regulations until the 1970s.

To understand Congressional resolve on this matter, one need only consider the long-term history of banking panics in the United States. Throughout the nineteenth and into the twentieth century the U.S. banking system had more panics than did the banking systems in Canada and Western Europe. Scholars now attribute these banking panics to a combination of factors, but emphasize that the U.S. banking system was fragmented and resource constrained. That is, most banks were single-unit, with no branches, at a time when there also was no Federal Reserve or deposit insurance. These isolated banks were susceptible to local currency failures and poor local economic conditions (e.g., crop or real estate failures) because they were unable to diversify assets or pool risks with other banks. Indeed, this was one rationale for the creation of federal deposit insurance during the New Deal.[124] However, Congress as well as policymakers generally erroneously credited the Glass-Steagall Act and its related regulations with controlling these panics over the course of the 20th century.[125] Hence, even as bank examiners came to support the need for regulatory relief, at least within the scope of their authority to interpret

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[124] Charles W. Calomiris and Gary Gorton, "The Origins of Banking Panics: Models, Facts, and Bank Regulation," in *Financial Markets and Financial Crises*, ed. R. Glenn Hubbard (Chicago: University of Chicago Press, 1991), 107-73 argue that a small number of national banks with widespread branches would have been much more stable.

[125] Christy Ford Chapin, "The Inadvertent Trigger: How Federal Policy Helped Activate Financialization," (presentation Policy History Conference, Tempe, AZ, May 16, 2018) argues the common view among social scientists that the U.S. economic system was stable after WWII is wrong.

banking regulations, no fundamental changes to the banking regulatory structure were possible until Congressional support of the Depression-era laws was overcome.[126]

The banking regulatory framework that Congress created during the New Deal incorporated traditional elements of banking in the United States. That is, while the Banking Act of 1933 was part of a comprehensive financial reform effort, some aspects of banking regulation preceded the New Deal legislation. Congress implicitly incorporated some of these more venerable aspects of the banking system into the New Deal framework by allowing them to stand as pillars of the specific Depression-era reforms. The two principal examples were the Federal Reserve System and geographic restrictions on bank branching.[127]

The United States had an ambivalent relationship with central banking, exemplified by the political battles over the first and second Banks of the United States (BUS). Once President Jackson vetoed the re-chartering of the second BUS in 1832, the United States had no central bank until the Federal Reserve System was created by Federal Reserve Act of 1913.[128] This law was passed in response to the Panic of 1907, which convinced bankers, policymakers, and legislators that the country required a strong central bank.[129] The Federal Reserve itself was created to serve as lender of last resort, the Federal Reserve System of public-private Federal Reserve banks to control the supply

[126] Carl Felsenfeld, "The Bank Holding Company Act: Has it Lived Its Life," Villanova Law Review 38, No. 1, 1993: 53-83.

[127] Wallach, "Competing Institutional Perspectives," 29-30.

[128] Markham, "Banking Regulation," 225-227

[129] Robert F. Bruner and Sean D. Carr, *The Panic of 1907: Lessons Learned from the Market's Perfect Storm* (Hoboken, N.J: John Wiley, 2009), 4-5.

of money, and the federal payment system.[130] Ironically, although the Federal Reserve was intended to stabilize the banking system through control of the monetary system, monetarists such as Milton Friedman criticize the Board of Governors of the Federal Reserve for exacerbating the banking panics of 1930-33 by tightening the money supply.[131] However, Friedman's judgement was retrospective. Despite any contemporary perceived failings, the Federal Reserve System was retained in the New Deal bank regulatory structure.

By way of background regarding geographic restrictions on banking, a dual chartering system for U.S. banks evolved over the course of the 19th century. In addition to its impact on central banking, the failure of the second BUS led to an explosion of state-chartered banks with local restrictions on intrastate branching. As of 1896, twenty states allowed branching, but usually only in the same city. Eight of those states later outlawed branching. Most states considered the practice illegal, and 13 states specifically prohibited bank branching.[132] In parallel, the National Bank Acts of 1863-1866, which formalized the dual federal-state system of bank regulation and created the Office of the Comptroller of the Currency to regulate national banks, also restricted branching for national banks. The McFadden Act of 1927 later specifically prohibited interstate

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[130] The National Bank Act, 12 Stat. 665, 25 February 1863; The Federal Reserve Act, PL 63-43, 23 December 1913

[131] Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States 1867 - 1960* (Princeton: Princeton University Press, 1993; 1963). See also Barry J. Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919-1939* (New York: Oxford University Press, 1992); Peter Temin, *Lessons from the Great Depression* (Cambridge, MA: MIT Press, 1989) who argue that the gold standard constrained authorities from adopting expansionary policies.

[132] Markham, "Banking Regulation," 232.

branching by national banks but allowed them to branch within their home state of operation subject to state laws.[133]

The upshot was that the unique American dual-chartering system with its characteristic geographic restrictions on bank branches was also retained in the New Deal banking regulatory structure along with the Federal Reserve System. Conversely, other laws passed subsequent to the New Deal continued to reinforce geographic restrictions and the federal regulatory structure. For example, the Douglas Amendment to the Bank Holding Company Act of 1956, which prevented bank holding companies from purchasing banks across state lines without permission from the states, was later added to reinforce the ability of states to protect smaller banks. As we will see, the retention of the dual state-federal oversight of banking, as well as the separation of federal authorities among the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Commission, and Office of Thrift Supervision had a significant long-term impact on future reform efforts by pitting these regulators against each other.[134]

As for the New Deal laws themselves, recall from the introduction that there were four primary aspects of the Depression-era banking regulatory structure. In addition to the geographic restrictions discussed above, the New Deal established federal deposit insurance, the separation of commercial banking from "riskier" activities, and interest rate controls. Each of these four pillars of banking regulation were thought to have specific strategic value in the unique U.S. banking regulatory structure.

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[133] PL-69-639, the McFadden Act of 1927, amended the Federal Reserve Act.

[134] BHCA § 3(d), 70 Stat. 133, 135. Kerry S. Cooper and Donald R. Fraser, *Banking Deregulation and the New Competition in Financial Services* (Cambridge, Mass: Ballinger Pub. Co.,1986), 145-170.

Federal deposit insurance was the one aspect of the New Deal that was never seriously targeted in the later efforts to repeal the Depression-era banking regulatory structure. The Banking Act of 1933 created the Federal Deposit Insurance Corporation (FDIC) to provide federal deposit insurance. Depository institutions were to pay dues into an insurance fund in order to protect the savings of customers and, as a result, prevent banking panics and runs on banks. According to Bert Ely, a long-time observer of banking reform measures, federal deposit insurance proved too effective as a deterrent to commercial bank failures and bank runs for there to be any serious interest in eliminating it. As a practical matter, deposit insurance remained a net positive for depository institutions as the guarantee it provided served as a selling point to customers from the 1930s into the twenty-first century.[135]

In parallel, the Glass-Steagall Act, which comprised four sections of the Banking Act of 1933, created a mandate to separate commercial and investment banking in order to isolate commercial banking from the perceived risk of investment banking. Sections 16 and 20 explicitly prohibited national and state member banks from underwriting and dealing in both corporate debt and equity securities. Section 21 prohibited depository institutions from underwriting securities more generally, with the exception of U.S. government obligations, as well as state, local, or municipal bonds. Finally, Section 32 prohibited the officers of member banks from engaging in the business of securities. Although these restrictions were reasonably clear, they contained exceptions. For example, non-member state banks were enjoined from securities activities, but not from

[135] Bert Ely, quoted in Steve Cocheo, "Curtain Raiser," *ABA Banking Journal* 90, No. 2, February 1998: 7. Although the Banking Act of 1933 created the FDIC, the later Banking Act of 1935 made the FDIC an independent agency.

affiliating with securities broker-dealers. Also, the restrictions on U.S. banks did not apply to their activities abroad.[136]

As a final element, the New Deal created a constrained interest rate environment for commercial banks. The Federal Reserve first issued Regulation Q in 1933 under the authority of Section 11 of the Banking Act of 1933. In addition to prohibiting the payment of interest on demand deposits, Regulation Q also imposed interest rate ceilings on savings and time deposits. By establishing a margin of return for depository institutions, the Federal Reserve intended to prevent excessive competition in the commercial banking industry. There were several reasons for this policy. One was to maintain stability among the various types of depository institutions by discouraging risky investments that might otherwise be taken to generate sufficient returns to pay higher interest rates on deposits. Another was to ensure that small banks as well as S&Ls had an adequate profit margin to remain in business. And finally, Regulation Q in a sense was a complement to federal deposit insurance. That is, given that the federal government was now to insure customer deposits, it sought restrictions to constrain the moral hazard this presented to banks that might otherwise take excessive risks on the understanding that they would be bailed out.[137]

Altogether, these elements formed the New Deal banking regulatory framework, which is sometimes loosely if erroneously referred to in aggregate as "Glass-Steagall." Congressional support for this framework remained strong until the 1970s. Clearly no

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[136] Pub. L. 73–66, 48 Stat. 162, June 16, 1933. See Hendrickson, "Glass-Steagall Reform", 857-858 for commentary. She argues that bankers were not prevented from executing securities orders for customers as long as they did not offer advice.

[137] Macey, Miller, and Carnell, *Banking Law and Regulation*, 30. Regulation Q was first promulgated by the Federal Reserve on 29 August 1933.

legislative action was possible as long as the consensus in support of the separation between commercial and investment banks remained.

What then were the factors that began to affect the willingness of policy-makers to acquiesce to industry demands for changes in the banking regulatory structure? The next sections will explore the efforts by some of the banking community to undermine Glass-Steagall, changing ideological consensus, shifting market conditions, and a crisis in the banking sector that made clear regulatory changes were necessary.[138]

Banker Opposition to Glass-Steagall

Although the unique U.S. regulatory approach to banking became widely accepted, it was never popular with the group it most directly constrained – the large commercial bankers. Indeed, these bankers fought hard to prevent the Glass-Steagall Act from being implemented.[139] Having lost that fight, thereafter they actively sought to reform the law. Failing to find traction in Congress to reform or repeal Glass-Steagall, bankers then turned to circumventing the separation of banking, securities, and insurance by exploiting loopholes in the law.[140]

Calls for reform of the New Deal financial regulatory structure began as far back as the 1930s. For example, in 1937 the Brookings Institution called for consolidation of regulatory authority over banks. Similarly, the Hoover Commission in 1949, Commission on Money and Credit in 1961, Hunt Commission in 1971, and the Financial Institutions and the Nation's Economy (FINE) Commission in 1974 all unsuccessfully sought to

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[138] Phillip A. Wallach, "Competing Institutional Perspectives," 26–48; Johnson and Kwak, *13 Bankers,* 74-82.

[139] George J. Benston, *The Separation of Commercial and Investment Banking,*18.

[140] Jerry W. Markham, "Banking Regulation: Its History and Future," *North Carolina School Banking Institute Journal* 4 (March 2000): 221-285.

rationalize banking oversight.[141] Advocates for repeal of Glass-Steagall had little success in convincing leading policy-makers in Congress and at the regulatory agencies. Indeed, the opposite was true. In the post-WWII years bankers frequently tested the regulatory limits of Glass-Steagall restrictions only to be shut down by Congress.[142]

Throughout this period Congress remained actively committed to the Depression-era framework, and sought to rein in bankers as they developed innovative ways around the laws. Consider the evolution of bank holding companies as one particular example of a market innovation that was coopted into the New Deal regulatory framework by Congress. Although the legal structure for holding companies had been available as a way to own banks and other subsidiaries since the early 1900s, in the 1950s it began to be used to circumvent branching restrictions placed on banks by creating interstate banking. Holding companies were also used to bypass restrictions on nonbanking activities by pushing those activities into subsidiaries and affiliates of the holding company. The intent of bankers was clearly to mitigate the effects of the Banking Act of 1933, including the Glass-Steagall portions of that law.

During this period there was a divergence among banking regulators as to how strictly to enforce the Glass-Steagall separations. For example, the FDIC generally held that Glass-Steagall did not apply to banks that were not members of the Federal Reserve.[143] On the other hand the Federal Reserve, which had to approve nonbanking

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[141] Henry S. Reuss and Fernand J. St. Germain, "Financial Institutions and the Nation's Economy Commission," Report to the Committee on Banking, Currency, and Housing, U.S. House of Representatives. Library of Congress, *The J.L. Robertson Papers*, Box 13, Washington, D.C., November 1975.

[142] Markham, "Banking Regulation," 221.

[143] Barth, Bumbaugh, and Wilcox, "Broad Banking,"191–204. By 1984, about half the states had laws that permitted such banks to have securities affiliates.

activities of bank holding companies, continued to interpret the banking laws reasonably strictly.[144] Indeed, the regulators at the Federal Reserve and OCC were often at odds. For example, the OCC sided with the large commercial bankers against Federal Reserve efforts in 1938, 1947, and 1949-1950 to get Congress to pass laws governing the formation of bank holding companies.[145]

Congress ultimately sided with the Federal Reserve and responded to bankers' innovations by passing the Bank Holding Company Act of 1956 (BHCA). This law placed the formation of multibank holding companies and their acquisition of banking and nonbanking activities under the regulatory purview of the Federal Reserve. The BHCA prohibited bank holding companies organized in one state from acquiring banks in other states unless specifically authorized by state law. And the law further required that any nonbank activity of the bank holding company had to be closely related to the business of banking. Thereafter, as a practical matter the BHCA was a part of the Glass-Steagall framework.[146]

Banking efforts to circumvent the Depression-era restrictions did not end with the BHCA. For example, in the fifties bankers sought to avoid Regulation Q restrictions by offering advertising premiums and other giveaways for new business. Similarly, in the 1960s banks began in earnest to challenge Glass-Steagall restrictions in order to expand their business bases. More importantly James Saxon, Comptroller of the Currency from

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[144] In *Board of Governors v. Agnew*, 329 U.S. 441 (1946) the Supreme Court affirmed that the Federal Reserve had the authority to remove bank directors with ties to securities companies. Later, in *Whitney Nat'l Bank v. Bank of New Orleans & Trust Co.,* 379 U.S. 411, 419, 85 S.Ct. 551, 556-57, 13 L.Ed.2d 386 (1965), the Supreme Court ruled that Board of Governors of the Federal Reserve System had exclusive jurisdiction to interpret and apply the BHCA.

[145] Wallach, "Competing Institutional Perspectives," 42.

[146] Spong, *Banking Regulation,* 26.

1961-1966, tentatively began to offer regulatory approval to the bankers' expansionary efforts by redefining what was considered "incidental to banking." For example, at the request of the large commercial bankers, Saxon allowed banks to sell data processing services, act as agents for insurance sales, offer travel services, and accept savings accounts from corporations. Other affected industries challenged these rulings, and the Comptroller sometimes lost in court. However, Saxon's efforts opened the door to regulatory redefinition of the banking laws, and his successors such as James Smith carried on that policy.[147]

Since the BHCA did not regulate holding companies that owned only a single bank, many large banks in the 1960s followed the lead of First National City Bank when it formed Citibank as a single-bank holding company. This corporate structure could then be used as a vehicle to perform financial services otherwise illegal for banks, as well as some nonfinancial activities. Why? Banking leaders such as Walter Wriston at Citibank were really interested in the flexibility offered by single-bank holding companies to diversify geographically by acquiring other depository institutions. Other vocal large bankers such as First Pennsylvania's John Bunting created fear of industrial and retail conglomerates by rash public statements. For example, Bunting once facetiously remarked that a one-bank holding company would allow a bank to own a car dealership if it wanted to do so. Ultimately, this issue divided the banking community as small

[147] Markham, "Banking Regulation," 239. See *Association of Data Process Service Organizations, Inc. V. Camp,* 397 U.S. 150 (1970); *Saxon v. Georgia Association of Independent Insurance Agents,* 399 F.2d. 1050 (5th Cir. 1968); *Arnold Tours, Inc. v. Camp,* 400 U.S. 45 (1970). See also Interpretive Letter from Comptroller James E. Smith to G. Duane Vieth (June 10, 1974) in *Federal Banking Law Reporter,* ¶ 96, 272.

bankers, championed by Congressman Wright Patman, sought to defend community banks against large banks diversifying geographically.[148]

Despite objections, the single bank loophole was simply too profitable for banks not to make use of it. By 1970, over a third of all commercial banking deposits were controlled by single-bank holding companies. This led Congress to amend the BHCA in 1970 to give the Federal Reserve authority over the formation and operation of single-bank holding companies in order to control their nonbank activities. The 1970 amendments also required the single-bank holding company to demonstrate a public benefit for the approval of nonbank activities, and applied the "closely related to banking" rule to the acquisition of subsidiaries by single-bank holding companies. In other words, Congress responded to bankers' innovative use of single-bank holding companies by regulating them in much the same way as the generic multi-bank holding company.[149]

As it turned out, even with the updated legal regulatory structure in 1970, single bank holding companies continued to be the corporate structure of choice for bankers. This was driven primarily by a 1971 tax ruling that permitted a closely controlled BHC to service bank acquisition indebtedness with tax-free dividends from the bank. In other words, the continued popularity of the bank holding company structure was the unintended consequence of a tax policy! There was no legislative or regulatory response to this 1971 tax ruling, which in effect created a significant advantage to the holding company structure despite the 1970 amendments to the BHCA. As a result, the holding

[148] Zweig, *Wriston,* 237-8. The public debate was colorful, with charges of Japanese *zaibatsu* prominent in opposition remarks, but there was never any real move to merge banking and commerce until the financial modernization debates in the 105th Congress.

[149] Spong, *Banking Regulation,* 27.

company became the most common form of commercial bank ownership, with over 96% of all bank deposits in 1999 under the control of banks held in holding companies.[150]

The failure of Congress to respond to this 1971 tax ruling marked the beginning of waning congressional resolve to support Glass Steagall restrictions in the face of an aggressive assault by the financial industry, and active support by all of the major federal banking regulators. Thereafter, Congress began to acquiesce passively as the Glass-Steagall restrictions were slowly eroded by regulatory and judicial rulings.[151]

One additional long-term impact of the shift in corporate preference for the single bank holding company structure was to tilt the balance of power among banking regulators from the OCC as the regulator of national banks to the Federal Reserve as the regulator of bank holding companies. Not only did the Federal Reserve have approval authority over the formation of holding companies, but also used its authority to impose capital adequacy standards on the underlying banks.[152] Phillip Wallach argues this shift in power marked an inflection point in the oversight by the Federal Reserve, which generally became more tolerant of the desire of large commercial banks to enter nonbank activities.[153] Regardless, the bureaucratic rivalry between the OCC and Fed continued for decades to come, and was to play a major role in the deliberations surrounding GLBA.

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[150] Spong, *Banking Regulation,* 27. This was not unprecedented, as tax rulings similarly led to the creation of Special Purpose Vehicles and Real Estate Investment Trusts (REITs).

[151] See Appendix 2 for a list of judicial rulings that eroded the original formulation of the New Deal era financial regulatory structure.

[152] Samuel B. Chase, "*The Structure of the Federal Regulation of Depository Institutions,"* Presented to the Committee on Banking, Currency, and Housing, U.S. House of Representatives, Library of Congress, *The J.L. Robertson Papers*, Box 13 (Washington, D.C., December 1975), 32. See also the *Federal Reserve Bulletin*, September 1972, 806-7.

[153] Wallach, "Competing Institutional Perspectives," 35.

For example, Robert C. Holland related an anecdote in which the Federal Reserve recommended to Congress that the Board should subsume the banking oversight role of the Office of the Comptroller of the Currency.[154]

The Intellectual Backdrop for Banking Deregulation

New macroeconomic issues that arose in the 1970s, including the frustrating advent of high inflation, oil shocks, high unemployment, and weak growth known as "stagflation," called the post-WWII policy consensus into question. Younger policymakers—those who had not lived through the Great Depression—began to consider new economic policies out of concern that the New Deal framework's combination of high taxes, fragmented financial markets, and strong regulation might actually be the cause of the economic woes. This new willingness to reconsider the New Deal regulatory framework extended to financial regulation.[155]

The end of the post-World War II Keynesian economic consensus resulted in a new regulatory paradigm sometimes termed "neoliberal."[156] After the economic dislocation and confusion of the late 1960s and 1970s, American voters, business leaders, and government officials concluded that the best economic policy was to allow the markets to self-regulate by dismantling much of the financial regulatory framework. This shift in the governing ideology was a necessary supporting factor in the decades-long

[154] Robert C. Holland, "*Statement by Board of Governors of the Federal Reserve,"* Presented to the Subcommittee on Financial Institutions Supervision, Regulation, and Insurance of the Committee on Banking, Currency, and Housing, U.S. House of Representatives. Library of Congress, *The J.L. Robertson Papers*, Box 13 (Washington, D.C., December 17, 1975), 14.

[155] Stein, *Pivotal Decade*, 117-125.

[156] Ott, *When Wall Street Met Main Street,* 3. For a fuller discussion of the term, see Angus Burgin, "The Neoliberal Turn," article pending publication, 2018.

piecemeal cooption of banking regulations that culminated in the eventual legislative repeal of Glass-Steagall.[157]

The deregulation movement, defined broadly, got its start when Alfred Kahn headed a team of technocrats in the Carter Administration who correctly asserted the government regulation of transportation had become dysfunctional. For example, federal guidelines prohibited airlines from engaging in price competition thereby driving up costs and leading to industry stagnation.[158] Once airline deregulation appeared successful, Kahn then turned his attention to land transportation industries of railroads and trucking. During the Reagan Administration, deregulation remained popular as seen most notably with the telecommunications industry and the judicially mandated break-up of ATT.[159]

The widespread acceptance of deregulation in some industries provided an opportunity for others, such as the financial industry, to promote the benefits of deregulation. For example, in 1972, the Board amended its Regulation Y, which governed bank holding company actions requiring approval by the Federal Reserve, and issued an interpretive ruling to enlarge the category of activities that it would regard as "closely related to banking" under §4(c)(8) of the BHCA. The particular activity at issue in this decision was to allow bank holding companies and their nonbanking subsidiaries to act as an investment adviser to a closed-end investment company. Although it took

[157] Cohen and DeLong, *Concrete Economics,* 171-187.

[158] Thomas Hopkins and Laura Stanley, "The Council on Wage and Price Stability: A Retrospective," *Journal of Benefit-Cost Analysis* 6, no. 02 (2015): 400–431. Arguably, the movement began under President Ford with the Council on Wage and Price Stability.

[159] Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions* (Cambridge, Mass: MIT Press, 1988) on deregulation in general.

time to work through the courts, the Supreme Court eventually held that this decision was within the Board's statutory authority.[160]

Similarly, in the securities industry, the SEC supported liberalization of rules governing investment banks and broker dealers. In 1970, the SEC began allowing investment banks to shift their ownership structure from partnerships to public companies, which had the effect of shifting risk from the partners to shareholders. Investment banks then took advantage of public ownership to generate an industry-wide merger wave in order to create economies of scale, but also to increase product offerings.[161] Further, in 1975, it banned fixed minimum commissions, thus promoting competition among brokers.[162]

Building on the economic crises of the 1970s, the banking industry and its lobbyists eventually convinced Congress that deregulation was the way to reduce systemic market risk and free up capital in response to banking failures and S&L crisis in the 1980s, as well as the 1987 stock market crash. The bankers were helped by the rising acceptance by policymakers of the Chicago School of economic thought, led by Milton Friedman, George Stigler, Ronald Coase, and Eugene Fama among others. Among banking regulators, faith in government regulation gave way to the neoliberal consensus,

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[160] *Board of Governors, FRS v. Investment Co. Inst.*, 450 U.S. 46 (1981)

[161] Alan D. Morrison and William J. Wilhelm Jr., "The Demise of Investment Banking Partnerships: Theory and Evidence," University of Virginia Law School (February 2005): 311-350.

[162] Silvers, "Deregulation and the New Financial Architecture," 434-436. These rules sometimes had unintended consequences. For example, when the SEC banned broker fixed commissions in order to protect investors, the decreasing margins it caused for the brokerage houses eventually led to their conversion from private partnerships to public corporations. This both increased the risk tolerance of managers and, by creating publicly held companies, set the stage for large scale mergers between investment and commercial banks.

which in banking was thought necessary to respond to on-going failures of the regulatory infrastructure to accommodate changes in market conditions to keep the U.S. banking system competitive.[163]

Judicial Empowerment

One important manifestation of the changing ideological environment was the shift in judicial interpretations to empower regulatory agencies. Although this trend was not specific to banking regulation, the long-term trend of regulatory actions that modified or in effect repealed aspects of the banking regulatory structure would not have been possible without judicial deference to the regulatory agencies. This judicial reinterpretation of regulatory authority came about as a result of the changing ideological consensus, a key precedent, and the deference of the courts to policy experts in the face of Congressional inaction.

As discussed by Steven Teles, there is little doubt that the courts were affected by the Chicago School's economic underpinnings of neoliberal policy.[164] For example, one manifestation of this phenomenon was the deference accorded to the writings of Richard Posner in the 1970s and Robert Bork in the 1980s, on the evolution of antitrust decisions.[165] Bork in particular was cited by the Supreme Court in over 30 decisions,

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[163] Milton Friedman and Rose D. Friedman *Capitalism and Freedom*, 40th anniversary ed. (Chicago: University of Chicago Press, 2002), first published in 1968, set the tone for the Chicago School of economic thought, which advocated this view. See also Harry M. Markowitz, "Portfolio Selection," *The Journal of Finance*, 7 (1) (March 1952): 77–91. This seminal article set out modern portfolio theory (MPT), which provided intellectual underpinning for financial deregulation.

[164] Steven Michael Teles, *The Rise of the Conservative Legal Movement: The Battle for Control of the Law (*Princeton: Princeton University Press, 2008).

[165] Richard A. Posner, *Antitrust Law: An Economic Perspective (*Chicago: Univ. of Chicago Press, 1976); Robert H. Bork, *The Antitrust Paradox: A Policy at War with Itself* (New York: Basic Books, 1978; New York: Free Press, 1993.

most notably in *Reiter v. Sonotone Corp.* (1979) in which the court explicitly adopted the Chicago School's approach to antitrust law.[166] The key point here was that the Court accepted Bork's argument that consumer welfare may be narrowly defined such that protection of competition was all that was required to protect consumers. Under this theory, which underpinned legal interpretations of the neoliberal consensus, it became unnecessary to limit the actions of large banks as long as competition could be maintained in the marketplace.[167]

In addition to this ideological shift by the court, a key precedent was established that the courts should defer to the interpretation of law by the relevant regulatory agency. In terms of the deregulatory campaigns by bankers via the Federal Reserve and OCC, the later Supreme Court decisions were driven by *Chevron v. NRDC* (1984). As with most common law, the judicial preference for the interpretations of the regulatory agencies evolved over time. However, once a judicial doctrine was adopted, it obtained persistence by the principle of *stare decisis*; that is, deference to precedent.[168]

Chevron itself had nothing to do with banking regulation. It was litigated over the right of the Environmental Protection Agency to interpret the Clean Air Act, and the result significantly empowered federal regulatory agencies. However, *Chevron* was less important for what it said about specific aspects of regulation than it was for providing a clear doctrine of deference to regulatory interpretation. In its decision, the Supreme Court

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[166] *Reiter v. Sonotone Corp.*, 442 U.S. 330 (1979).

[167] George L. Priest, "Bork's Strategy and the Influence of the Chicago School on Modern Antitrust Law," *The Journal of Law and Economics* 57, no. S3 (August 1, 2014): S1–17. https://doi.org/10.1086/676462.

[168] *Chevron, U.S.A. Inc. v. NRDC, Inc.,* 467 U.S. 837, 842-45, 104 S.Ct. 2778, 2781-83, 81 L.Ed.2d 694 (1984). See https://www.law.cornell.edu/wex/stare_decisis for a discussion of the legal doctrine of stare decisis. Note that this precedent is potentially under challenge by recently appointed conservative members of SCOTUS.

laid out the principle of judicial deference to an agency's interpretation of its governing statute. Specifically, it determined that the courts must enforce the unambiguously expressed intent of Congress, but that if congressional intent is unclear the courts should defer to the agency's "permissible construction."[169] The Supreme Court further defined an agency's permissible construction as one that is "rational and consistent with the statute." This approach allowed the regulatory agencies a great deal of leeway.[170]

The *Chevron* doctrine was not without limits. For example, in *Treasury v. FLRA* (1988), the D.C. Circuit Court ruled that the *Chevron* doctrine did not apply "when an agency interprets a statute other than that which it has been entrusted to administer, its interpretation is not entitled to deference." Although this case was about collective bargaining rather than deregulation, it established the limits of *Chevron* that could be applied to the banking deregulation cases. By way of illustration, the OCC would not be offered deference by the courts if it were to interpret the BHCA because that law is primarily executed by the Board, not the OCC.[171]

Two similar cases before and after *Chevron* illustrate the evolution of judicial interpretation over time. First, *Investment Company Institute v. Camp* (1971) was an important Supreme Court decision that established much of the basis for jurisprudence as regards the Glass-Steagall framework. In this case the Investment Company Institute (ICI), a securities industry trade association, sued William B. Camp in his official

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[169] *Chevron, U.S.A. Inc. v. NRDC, Inc.,* 467 U.S. 837, 842-45, 104 S.Ct. 2778, 2781-83, 81 L.Ed.2d 694 (1984). In *ICI v. Camp* the Court said that "great weight" should be given to "any reasonable construction of a regulatory statute adopted by the agency charged with the enforcement of that statute."[169]

[170] *NLRB v. United Food & Commercial Workers Union, Local 23,* U.S., 108 S.Ct. 413, 421, 98 L.Ed.2d 429 (1987).

[171] *Department of the Treasury v. FLRA,* 837 F.2d 1163, 1167 (D.C.Cir.1988).

capacity as Comptroller of the Currency over the decision by the Office of the Comptroller of the Currency (OCC) to allow First City National Bank (now Citigroup) to operate an open-ended investment fund. Such a fund, which sold shares of the fund itself to investors rather than the underlying stocks owned by the fund, was typically the purview of broker-dealers. In one sense the decision was an unremarkable rebuke to the OCC during the 1970s, in keeping with the court's deference to Congressional intent under the Glass-Steagall framework.[172]

However, in another sense *ICI v. Camp* was important because the Court undertook to outline the legislative intent of the Glass-Steagall framework and provide a "subtle hazards test" for bank safety and soundness. This phrase became a term of art to describe the hazards, or pressures to act in favor of a stock the bank's affiliate might own, that may occur when commercial banking enters the securities business. This standard and its implied deference to Congressional intent were then leveraged for future litigation involving regulatory interpretations of appropriate authorities for national banks.[173]

After *Chevron* the Courts began deferring to the regulatory construction offered by the banking supervisors. As we will see, the Federal Reserve, FDIC, and OCC all began to interpret the National Bank, Glass-Steagall, and Bank Holding Company acts in ways that permitted commercial banks to undertake activities similar to securities underwriting and sales. For example, in *ICI v. Conover* (1986) the DC court of appeals

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[172] *Investment Company Institute v. Camp* 401 U.S. 617 (1971).

[173] The "subtle hazards" became issues the OCC, FDIC, or Board must address before approving a nonbank activity for a BHC or bank. For example: impairment of public confidence; compromise of the bank's integrity in judging credit for loans based on its "salesman interest" in the success of its affiliate; conflict between the promotional interest of a securities affiliate and the fiduciary duty of the bank to provide sound investment advice.

upheld the OCC's regulatory interpretation that Citibank could create and operate an investment vehicle it called a "collective investment trust" (CIT) to be held in Individual Retirement Accounts (IRA). These so-called CITs functioned similarly to a mutual fund and the securities industry contended that shares in the CITs were in fact securities under the meaning of Glass-Steagall. This meant that banks could not underwrite, hold, or sell them under Glass-Steagall. However, the court determined that Congress had not addressed this particular issue in law, and that under *Chevron* it was within the Comptroller's authority to determine if this new investment vehicle was a security for the purposes of Glass-Steagall.[174]

Such a significant evolution in judicial interpretation of banking regulation did not happen simply because of the shifting ideological climate or the *Chevron* precedent. A final factor driving judicial empowerment was the failure of Congress to act to preserve or clarify the Glass-Steagall framework after the 1970 amendments to the BHCA. That is, the banking regulatory agencies were significantly empowered by judicial deference in the face of the continuing failure of Congress to act. Wallach argues that, "As the 1980s wore on and Congress did not defend its prerogatives, it made less and less sense to the courts to hold the line on bureaucratic action intended to make the banking system more rational and responsive to economic conditions as well as regulatory oversight more consistent waiting for Congress to act." Instead, given their

[174] *Inv. Co. Institute v. Conover*, 790 F. 2d 925 - Court of Appeals, Dist. of Columbia Circuit 1986. See also *Investment Company Institute v. Federal Deposit Insurance Corporation,* 815 F. 2d 1540 (1987) in which the FDIC interpretation that nonmember banks were not bound by the Glass-Steagall Act was upheld.

limited capacity and resources, judges deferred to experts in hopes of achieving a "consistent, sensible legal environment for banks."[175]

The bottom line was that the courts began to defer to the expertise of bureaucrats in order to establish a competitive U.S. banking market in the absence of Congressional action. While the courts still occasionally ruled against the Board of Governors of the Federal Reserve or Office of the Comptroller of the Currency if their respective interpretations went against a statute's clear intent, from this point forward both the Board and the Comptroller were empowered by the courts' general approach to regulatory agency interpretation of existing law.[176]

Market Factors: Cracks in the Foundation of Banking Regulation

In addition to the general pressure placed on banks from broad economic and market conditions that faced the country in the 1960s and 1970s, banks faced several specific challenges to their business model. These challenges included the inability to offer competitive interest rates on deposits in an inflationary environment, competition from the securities and insurance industries, a technology-driven blurring of financial products across demarcated regulatory lines, an increase in competition from international banking, as well as direct competition from thrifts. In other words, U.S. commercial banks lost their competitive edge. This section highlights the factors that led to the loss of competitiveness by commercial banks within the Depression-era banking framework.

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[175] Wallach, "Competing Institutional Perspectives," 41.

[176] *Securities Industry Assn. v. Board of Governors*, FRS, 468 US 137 - Supreme Court 1984; American Land Title Ass'n v. Clarke, 968 F. 2d 150 - Court of Appeals, 2nd Circuit (1992)

The fundamental issue faced by depository institutions from the late 1960s through the 1970s was the inability to compete for deposits in an environment of high and unstable interest rates during a period of rising inflation. Regulation Q limits on interest rates were only workable as long as market interest rates remained low and relatively stable, as they had for several decades after World War II. With the prime interest rate peaking at 21% in 1980, customers were less willing to accept the low interest rates offered by depository institutions. Since banks were constrained by Regulation Q from offering interest rates that could protect the value of depositors' money during an inflationary period, they suffered disintermediation. That is, there was a broad trend to shift financial resources from commercial banks to capital markets where savers and investors sought market rates of return and where other financial institutions sought to mimic the functions of banks.[177]

Disintermediation was facilitated by the development of a number of alternatives to bank deposits over the course of the 1970s. One simple example was that savers turned to U.S. Government instruments such as Treasury bills. However, these instruments had some disadvantages. In particular, T-bills required more effort on the part of savers to invest and required deposits for fixed investment periods. This led other financial services institutions to offer innovative products that could keep up with market interest rate movements but also provide ease of use.[178]

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[177] Alan S. Blinder, "The Anatomy of Double-Digit Inflation in the 1970s," in *Inflation, Causes and Effects*, National Bureau of Economic Research Project Report, ed. Robert E. Hall (Chicago: University of Chicago Press, 1982): 261-282; Johnson and Kwak, *13 Bankers*, 84.

[178] Dorene Isenberg, "The Savings and Loan Crisis and Bailout: Lessons for Policy," in *The Handbook of the Political Economy of Financial Crises, eds.* Martin H.

The securities industry in particular was able to leverage information technologies and advanced data processing to offer new services at the retail level to act as substitutes for bank deposits. Indeed, Henry Brown and Bruce Bent first invented the money market mutual fund (MMF) in 1971 specifically for the securities industry to bypass Regulation Q restrictions. As it turned out, the advent of the MMF was a key innovation that facilitated disintermediation.[179]

Why did MMFs present such a serious challenge to bankers? First, broker-dealers could offer higher interest rates than bank deposits with these funds because, in addition to not being subject to Regulation Q, they bypassed many restrictions imposed on bank accounts such as reserve requirements. Second, the broker-dealers continued to develop a parade of new features such as check-like writing on the MMF account. For example, Merrill Lynch opened the first cash management account (CMA) later in the 1970s, which was a brokerage product that included a money market account with check-writing privileges. These CMAs obviously were in direct competition with traditional checking and savings accounts for deposits, and were intended to enable the securities firms to hold a larger share of client assets. More to the point, they provided a ready alternative when bank deposits became unpalatable to consumers. As a result, while money market mutual fund only amounted to $3 billion in 1976 they grew to over $230 billion by 1982.[180]

Wolfson and Gerald A. Epstein (New York, NY: Oxford University Press, 2013), 415-662.

[179] Markham, "Banking Regulation," 241. See especially FN 118.

[180] Macey, Miller, and Carnell, *Banking Law and Regulation*, 29-31; Markham, "Banking Regulation," 241.

While bank withdrawals occurred throughout 1970s, the massive outflow of deposits between 1978 and 1980 created a crisis. This led banks to fight back with innovations of their own. For example, commercial banks tried financial innovations such as Negotiable Order of Withdrawal (NOW) interest bearing deposit accounts. These accounts were designed to comply with Regulation Q but get around the restriction that demand deposits could not pay interest. Banks also leveraged certificates of deposit (CDs). These instruments allowed banks to offer market competitive rates that again were not subject to Regulation Q limitations. Of course, CDs also had limitations. For example, they required customers to lock in their savings for set periods. So, despite bankers' efforts to stem the tide, the net result was that by the 1980s the social compact under which depository institutions accepted interest rate restrictions appeared to be irretrievably broken.[181]

Beyond interest rate driven disintermediation, both insurance companies and securities firms also pressured banks by leveraging loopholes in the banking laws such as the "nonbank" bank. Prior to 1987, a bank was defined for purposes of the BHCA as institution that met two functional requirements: it accepted demand (checking) deposits and made commercial loans. A so-called "nonbank" bank, also sometimes called a limited-purpose bank, deliberately avoided one of these two functional requirements in the strict definition of a bank for BHCA purposes. The Federal Reserve and OCC acknowledged that limited purpose banks did not violate the BHCA as long as they did not both accept demand deposits and make commercial loans. If such a "bank" was

[181] Mason, *From Buildings and Loans to Bail-Outs*, 190.

chartered, it could either accept savings deposits but not demand deposits, or make consumer but not commercial loans.[182]

These nonbank banks had significant advantages over traditional commercial banks. In many ways, they were treated the same as commercial banks. They could be chartered and were eligible for federal deposit insurance. Yet while they were therefore subject to bank examination for safety and soundness, they were not subject to the geographic restrictions on bank branching faced by commercial banks. For example, in 1983-84 Dimension Financial Corporation applied to form a 25-state network of 31 nonbank banks. Naturally, this ability to bypass branching restrictions offered the insurance and securities firms a competitive advantage as they sought to contend with commercial banks for the profits associated with new financial products.[183]

The limited-bank model posed a significant threat to commercial banking. By 1982, over 60 of these nonbank banks had been chartered by either securities or insurance parent companies in equal proportions. As a result, nonbank banks were strongly opposed by federal bank regulators because of the threat they presented to the commercial banking industry. Comptroller C. T. Conover imposed a moratorium on new nonbank banks in

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[182] Lissa Broome and Jerry W. Markham, "Banking and Insurance: Before and After the Gramm-Leach-Bliley Act," *Journal of Corporation Law* 25, no. 4 (2000): 723; Nancy L. Ross, "Non-Bank Loophole Wide Open," *Washington Post*, October 11, 1984, D1; Donald R. Fraser and James W. Kolari, *The Future of Small Banks in a Deregulated Environment* (Cambridge, Mass: Ballinger Pub. Co, 1985), 228-229. In 1982, in reference to the proposed acquisition by the Dreyfus Corporation of the Lincoln State Bank of New Jersey, the Federal Reserve ruled that an organization that purchased money market instruments such as commercial paper or CDs was making commercial loans for purposes of the BHCA.

[183] Steve Cocheo, "Of Maps and Men," *ABA Banking Journal* Vol. 90, No. 5 (May 98): 7-9. In a rare judicial loss for the Federal Reserve, *Dimension Fin. Corp*., 474 U.S. 361, at 362 decided that the Fed could not redefine the BHCA definition of a bank through regulation.

1983, but remarked that unless Congress closed the BHCA loophole he would have no choice but to continue to approve the formation of more. In 1984, the OCC faced a backlog of 329 applications, the FDIC 20, and the Federal Reserve two. Commercial bankers, notably represented by the ABA and IBAA, strongly lobbied to close the BHCA loophole, which was finally eliminated in 1987 by the Competitive Equality Banking Act (CEBA).[184]

In addition to competition for deposits from the securities and insurance industries, commercial banks also faced the loss of commercial lending to retail companies. As discussed in the literature review, this shift in financial markets was part of the growing phenomenon of financialization whereby retail businesses shifted focus to making profits by means of financial instruments.[185] The net result for commercial banks was that the finance departments of large retail firms began to undertake a more direct role. One way this phenomenon played out was when manufacturers leveraged their own finance divisions to fund purchases, as with the major auto manufacturers. Another way retail firms profited was by cutting out the banks as a financial intermediary.[186] As Aurthor Murton of the FDIC explained, "To a greater extent than ever before, businesses have replaced bank financing with capital-market financing. Businesses increasingly are

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[184] Ross, "Non-Bank Loophole Wide Open," D1; Competitive Equality Banking Act (CEBA), Pub. L. No. 100-86, 101 Stat. 552 (1987), amending 12 U.S.C. section 1757(s). In a foreshadowing of the resolution to the unitary thrift issue that arose in the 1990s, existing nonbank banks were grandfathered.

[185] Chapin, "The Inadvertent Trigger," 1 offers this definition of financialization: "Financialization is a term that describes how, in the U.S. economy, profitmaking through financial instruments has increased in importance in comparison to profitmaking through the production of goods or through other service activities." See also Rockman, "What Makes the History of Capitalism Newsworthy,"439–466; Davis, *Managed by the Markets, 112;* and Krippner, *Capitalizing on Crisis,* 27-57.

[186] Cohen and DeLong, *Concrete Economics,* 162.

able to meet their funding needs by issuing commercial paper, debt securities and equity, rather than by borrowing from banks."[187]

U.S. commercial banks also faced pressure from international competition, which became a concern to U.S. policy-makers as the financial sector grew in importance to the overall economy. Before 1978 foreign universal banks were able to invest in the U.S. through branches subject to state supervision only. These branches were not subject to Glass-Steagall restrictions, which gave them significant competitive advantages. For example, foreign owned bank branches were not bound by the Regulation Q interest rate restrictions that governed U.S. banks. Neither were they governed by the geographic restrictions on branching and interstate operations that limited U.S. banks. These foreign bank branches were also not subject to U.S. capital restrictions, and their own national reserve requirements were often less strict. Finally, they were not required to obtain or pay the assessments for federal deposit insurance. While various measures were undertaken to reduce the competitive advantage held by foreign banks, U.S. banks remained at a disadvantage throughout the 1980s.[188]

[187] Aurthor Murton, "Testimony of Aurthor Murton Director Division of Insurance Federal Deposit Insurance Corporation on Technology and Banking," presented at the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises Committee on Banking and Financial Services United States House of Representatives, Washington, D.C. (March 25, 1999): 1-2.

[188] Macey, Miller, and Carnell, *Banking Law and Regulation,* 801-802; Spong, *Banking Regulation,* 185. Most of the advantages held by foreign banks were removed by the *International Banking Act of 1978* (IBA), 12 CFR §211.23, which nominally aimed for competitive equality with U.S. banks. However, foreign banks were able to establish exemptions to key provisions of the IBA by obtaining a "qualified foreign banking organization" determination from the Federal Reserve, which required that more than half its business be in banking, and greater than 50% of its banking business be outside the U.S.

According to Federal Reserve Governor Lawrence Meyer, American bankers also became more international in focus as commercial banks increased cross-border transactions to operate free from Regulation Q restrictions.[189] Unfortunately, the efforts of U.S. banks to seek profits abroad exposed them to volatile international financial conditions. The ultimate impact was a series of crises in the international financial system that had a negative impact on the revenue of U.S. banks. These included the Latin American defaults of the 1980s, which gave way to the 1992 currency crisis in the European Monetary System, which was in turn followed by the Asian financial crisis of 1997.[190]

One final challenge for commercial banks was competition from the thrift industry. In particular, thrifts were not subject to Regulation Q interest rate restrictions until 1966, when the Interest Rate Control Act was passed. Even after that, thrifts were allowed a favorable interest rate differential with banks. That is, they could offer a higher rate on deposits than could commercial banks nominally in compensation for the limited range of customers services that S&Ls could offer (e.g., no checking accounts or consumer loans).[191]

The competition between banks and thrifts was exacerbated by the S&L crisis. Briefly, the S&L crisis was brought about by many of the same economic forces as the banking industry, but the thrift industry was in a much more tenuous position given the

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[189] Laurence H. Meyer, "Issues and Trends in Bank Regulatory Policy and Financial Modernization Legislation," Remarks presented at the Bank Administration Institute, Finance and Accounting Management Conference, Washington DC, (June 9, 1998):1-8. This 42% decline was somewhat caused by bank failures during the S&L crisis, but more recently it was mergers among healthy banks. In the 1990s it was common to see over 400 mergers a year.

[190] Wolfson, "An Institutional Theory of Financial Crises,"177-179.

[191] White, *The S&L Debacle,* 62-64.

narrow focus of the industry on mortgages and community lending as well as a chronic underfunding of the Federal Savings and Loan Insurance Corporation (FSLIC).[192] A true crisis ensued. In 1980, there were approximately 4,000 federal and state-chartered savings and loan institutions with assets of about $604 billion. Net income for the industry fell from $780 million in 1980 to negative $4.1 billion in 1982. Over those three years, 118 thrifts failed, costing the Federal Savings and Loan Insurance Corporation (FSLIC) $3.5 billion to resolve. Additionally, there were 493 voluntary mergers and 259 supervised mergers of savings and loan institutions. Despite this activity, at the end of 1982 an additional 415 thrifts with assets totaling $220 billion were insolvent based on their net worth.[193]

As a result of the S&L crisis, Congress undertook a series of measures to allow thrifts more flexibility in product offerings and generally align regulation with that of commercial banks. These changes and others were codified in three 1980s era laws primarily directed toward rescuing thrifts, but that nevertheless had implications for the

[192] The S&L crisis is well documented. David L. Mason, *From Buildings and Loans to Bail-Outs: A History of the American Savings and Loan Industry, 1831-1995* (New York: Cambridge University Press, 2004); Lawrence J. White, *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation* (New York: Oxford University Press, 1991); and George J. Benston and George G. Kaufman "Understanding the Savings and Loan Debacle" *Public Interest (*Spring 1990) all provide in depth treatments of the S&L crisis.

[193] *An Examination of the Banking Crises of the 1980s and Early 1990s*, Vol. 1, (Washington D.C.: FDIC, 1997), 169; and Isenberg, "The Savings and Loan Crisis and Bailout," 661. There were other contributing factors to the crisis. The extent to which they factored in to the overall series of thrift failures varies. One was the adoption by several important states, including California, Florida and Texas, of deregulation beyond that of the federal government. This became important to the overall S&L story because the concentration of S&L in constructions loans, followed by the collapse of real estate prices in each of these heavily populated states, accounted for a large percentage of the second wave of S&L failures post-1986.

banking industry as a whole.[194] One particular unanticipated effect of the policy responses to the S&L crisis was to increase the pressure on commercial banks as the two industries converged. That is, the deregulation of the thrift industry allowed S&Ls to undertake a number of services traditionally offered by commercial banks. These included: offering checking accounts; making commercial and consumer loans; offering credit cards; providing trust services; and even calling themselves "banks" if they preferred. In many ways, the typical retail customers could no longer tell the difference between a commercial bank and S&L, at least at the branch level.[195]

The net impact of all these market factors on banks, from the impact of high inflation, technological changes, and structural rigidity in regulation, was a growing competition with the securities and insurance industries, as well as both international banks and domestic thrifts. Although U.S. banks dominated the world after WWII, by the mid-1970s only four of the top 20 banks in the world were American. And, as a result,

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[194] Mason, *From Buildings and Loans to Bail-Outs,"* 266-274. These laws were the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), Garn St. Germain Depository Institutions Act of 1982 (Garn-St. Germain), and the Financial Institution Reform, Recovery and Enforcement Act of 1989 (FIRREA). In effect, the savings and loan industry was re-regulated under new management, as the FHLBB and FSLIC were abolished and the FDIC was given responsibility for the Resolution Trust Corporation (RTC) and new Savings Association Insurance Fund (SAIF). The RTC was set up to resolve all insolvent thrifts in two years with $50 billion.

[195] Johnson and Kwak, *13 Bankers*, 35. Despite convergence, legal differences remained between thrifts and commercial banks at the beginning of the 1990s Among the more important remaining distinctions between commercial banks and thrifts after the Financial Institution Reform, Recovery and Enforcement Act of 1989 was passed were: Thrifts remained more constrained on investments (e.g., federal savings association could not have more that 20% of assets in commercial loans and commercial loans exceeding 10% must be to small businesses); thrifts must meet a "qualified thrift lender tests" (QTLT) by keeping a certain percentage of assets in home mortgages or risk being regulated as banks or Bank Holding Company (BHC); and finally, the Bank Holding Company Act of 1956 generally did not apply to a thrift holding company (THC) if it owns no banks and all subsidiary thrifts meet the QTLT.

the competitiveness of U.S. banking became an overriding concern of U.S. policy-makers when it became apparent that these market factors were having a significant negative impact on the banking industry.[196]

Banking Failures: A Hidden Crisis

Although the S&L crisis gets more public attention, there was a parallel crisis in banking that is much less well-known. From the mid-1930s through the early 1970s there was an absence of financial and banking crises. In other words, there were no systemic failures, or panics, and of the individual banks to fail none were significant. This trend appeared to validate the New Deal banking regulatory structure. However, beginning in the 1970s, both individual bank and systemic failures began to occur due to disintermediation. Eventually, over the period 1979 to 1994, over one-third of independent banks disappeared. These failures fundamentally challenged assumptions about the banking regulatory system in ways not seen since the Great Depression.[197]

In 1974, for example, Franklin National Bank was the first major failure of a commercial bank since the 1930s. Its collapse caused a crisis in the domestic market for large negotiable CDs.[198] This might have been attributable to unique conditions or poor management on the part of bank management, but Franklin National was only the first. Commercial banks began to fail at rates unseen since the Banking Act of 1933 was passed. This trend mostly consisted of small commercial banks, as well as mutual savings banks, which faced the same threats that were documented in the S&L crisis. However, some large banks failed too, including the four largest banks in Texas, primarily because of the geographic concentration of failed real estate loans.

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[196] Markham, "Banking Regulation," 238-252.
[197] Berger, "Long, Strange Trip," 82.
[198] Wolfson, "An Institutional Theory of Financial Crises," 177-179.

Allen Berger and his coauthors calculated from unpublished FDIC data an increase from fewer than ten failures per year early in the 1980s, to over 200 per year by the end of the decade. There were a total of approximately 1,450 bank failures in this period at a cost of $51 billion in 1994 dollars. While in some cases this phenomenon simply reflected industry consolidation, a significant portion of these losses represented bank failures due to a combination of market conditions, external competition, and costs associated with changes in interest rate regulation.[199]

These banking failures were partially driven by broader factors beyond the individual circumstances of the banks. In one sense the crisis in banking was a regulatory failure. William Black attributes the failures to a deliberate policy of constrained bank examination due to regulatory capture. He argues further that the staffs at the Federal Home Loan Bank Board (FHLBB) were either unwilling or unable to respond to the dynamic response unleashed by the deregulation and culture of growth that took hold of the thrift industry in the 1980s.[200] In addition, poor policy choices were made. For example, the Little Rock FHLBB was moved to Dallas at the height of the crisis. Only 11 of the examiners elected to move, causing a reduction in examinations of over 36% in the area that was the geographical heart of the banking and S&L crisis.[201]

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[199] Berger, "Long, Strange Trip," 82.

[200] William K. Black, "Current State of the Savings and Loan Industry," *Antitrust Law Journal* 58, no. 2 (August 1989): 500-502. See also Norman Strunk and Fred Case, *Where Deregulation Went Wrong: A Look at the Causes behind Savings and Loan Failures in the 1980s* (Chicago: United States League of Savings Institutions, 1988), 141 which argues that regulators believed that they could actually be effective with fewer personnel given the advent of information technologies.

[201] George J. Benston and George G. Kaufman "Understanding the Savings and Loan Debacle" *Public Interest (*Spring 1990): 85.

Ultimately, a systemic risk evolved as individual financial institutions began to take additional risks in order to restore profitability. In other words, additional risk taking by individual institutions led to cascading failures. For example, the investment bank Drysdale Securities overextended itself in the secondary government bond market, and when its investments went wrong it was unable to pay Chase Manhattan Bank, which was the commercial bank that was buying government securities for Drysdale. The subsequent failure of Drysdale, and losses at Chase Manhattan when Drysdale was unable to pay Chase Manhattan for the securities it was holding, led to a severe disruption of the government securities market.[202]

Some failures defied simple explanation, as with a depositor run on the Bank of New England, which occurred despite federal deposit insurance. But others were easier to explain. For example, the interconnectedness of the banking system became a problem when the failure of Penn Square Bank, a small bank in Oklahoma, caused losses at 44 different banks that had lent funds through Penn Square. This included "too big to fail" Continental Illinois National Bank, which required a federal bail-out.[203]

One problem with the government's response to these failures was that it was unclear what criteria it would apply to merit an intervention. For example, Penn Square was allowed to fail in 1982, but in 1983 when Continental Illinois faced a "silent run" the government deemed it "too big to fail." The government then recapitalized the bank in order to protect not only insured depositors, but also uninsured claimants on the bank.[204]

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[202] Macey, Miller, and Carnell, *Banking Law and Regulation*, 36-37.

[203] Macey, Miller, and Carnell, *Banking Law and Regulation*, 36-37.

[204] Douglas Elmendorf, "What Market Failure Would Be Addressed by Further Government Regulation of Risk-Taking of Financial Institutions," Council of Economic Advisors (December 7, 1998), William J. Clinton Presidential Library & Museum.

The lack of clear direction from Congress led the bankers and the associated policy community, including regulators, to lobby Congress to create new legislation to reestablish regulatory certainty. The bankers contended that their competitiveness could only be restored by steps taken in parallel to break interest rate restrictions, ease geographic barriers, and free banks from the restrictions of Glass-Steagall. However, the piecemeal response of Congress to the S&L crisis in the 1980s demonstrated that comprehensive banking reform was unlikely. Any ultimate solution would require a fundamental restructuring of regulatory environment. As a result, banks, their trade associations, and banking interest groups all continued to seek additional relief in the form of legislative, regulatory, and judicial deregulation in order to enhance their competitiveness.

Implications for New Deal Era Regulations

New Deal banking regulatory laws were part of a public-private sector bargain. They were designed to keep America's savings safe in depository institutions that were regulated and insured, but also protected from the risks of securities and insurance underwriting. As we have seen, beginning in the 1970s, that bargain began to break down as market conditions appeared to validate long-running efforts by bankers to reform the regulatory system. And, from the bankers' perspective, if the government could not provide economic conditions in which banks could be profitable under the Depression-

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Elmendorf demonstrated that senior government economists understood quite well they were potentially creating a systemic risk in repealing Glass-Steagall. Elmendorf argued, "One specific effect of asymmetric information is to increase the risk of a general financial panic …The doctrine of "too big to fail" is based on this point. This externality increases the chance of a self-fulfilling drop in activity that monetary policy would not be able to counteract. Note that the Federal Reserve's key argument for why it should be involved in bank regulation is that understanding of bank conditions is critical to making monetary policy."

era regulatory structure, they had every incentive to try to unshackle themselves to enhance their profitability.

Hence the financial services industries, at first led by commercial banks but later broadly supported by the securities and insurance industries, began a multi-decade concerted effort to repeal the framework of laws and regulations that were consolidated during the Great Depression. This approach was partially successful. In the 1980s and early 1990s many legislators, regulators, and financial services industry leaders became persuaded that disintermediation, competition from foreign banks, loss of profitability, breakdown in the old regulatory structure, and private sector actions to blur the distinction among financial institutions all combined to render the old banking regulatory structure obsolete.

This section briefly describes three sequential campaigns to remove key components of the New Deal regulatory structure. Two of these deregulatory campaigns--interest rate restrictions and geographic barriers to bank branching and interstate banking-- were successful and demonstrated to bankers the value of a sequential approach to deregulation. This lesson was reinforced when, between the legislative changes to interest rate and geographic restrictions, an early abortive effort at repealing Glass-Steagall, demonstrated that Congress was not yet ready for comprehensive reform of the Depression-era laws.

While the resulting deregulation of the banking industry did not succeed in repealing Glass-Stegall, the impact on of the two successful deregulatory campaigns on the New Deal financial regulatory structure was profound. In fact, changes to interest rate and geographic restrictions led to the most significant banking consolidation U.S. history as bankers sought to create more competitive financial institutions with greater economies of scale. According to the FDIC, "From 1990 to 1998, the number of FDIC-insured institutions in the United States declined from 15,796 to 10,461. Although bank and thrift failures contributed to this shrinkage, failures accounted for only 907 banks and thrifts out of the 5,335 institutions that left the industry during this period."[205]

The significance of the sequential nature of the on-going repeal effort lay in the manifest difficulty of considering an overarching reform of the banking regulatory structure. Instead, the evidence suggests that Congress was not prepared for wholesale change and instead preferred an evolutionary approach. However, this pattern of incrementally dismantling the key components of the New Deal financial regulatory structure supports this dissertation's argument that the distraction of focusing on the repeal of Depression-era laws obscured the need for innovative reforms in response to dynamic financial services markets.

Interest Rate Deregulation in the 1980s

Of the three campaigns, the drive to repeal Regulation Q interest rate restrictions was the most pressing. As discussed under "Market Failures," the economy endured high inflation and high unemployment in the late 1970s, and commercial banks and thrifts suffered disintermediation from the poor business conditions. By 1980, Regulation Q limited interest rates on deposits to 7.5%, but market interest rates were closer to 12-13%, which was obviously untenable over the longer term. Not only were the high short-term interest rates that were becoming available to savers and investors at nonbank alternatives

[205] Aurthor Murton, "Testimony of Aurthor Murton Director Division of Insurance Federal Deposit Insurance Corporation on Technology and Banking," presented at the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises Committee on Banking and Financial Services United States House of Representatives, Washington, D.C. (March 25, 1999): 1-2.

squeezing deposits at regulated banks and thrifts, but low long-term locked in rates on loan instruments such as mortgages meant that regulated depository institutions were losing money on their assets. So, despite bankers' efforts to compete in the market through innovations such as negotiable order of withdrawal (NOW) accounts and expanded use of certificates of deposits, bankers eventually had to turn to Congress for legislative relief.[206]

The American Bankers Association (ABA) first made it policy to seek elimination of Regulation Q restrictions in 1977.[207] Their fundamental argument was that the entire banking system was at risk if Congress allowed disintermediation to continue. However, chief lobbyist Edward Smith was adamant about a related point: state usury laws had to be preempted by federal law if Regulation Q restrictions were lifted. Indeed, if banks were required by the market to pay even higher interest rates on deposits but could not in turn charge competitive rates on loans it would have further accelerated the breakdown of the banking model. In addition, the ABA was supported in its lobbying efforts by community bankers, who had previously supported Regulation Q for the protections it provided their business model. The community bankers changed their support for Regulation Q under pressure from small savers who were losing pricing power to inflation by leaving their savings in bank accounts.[208]

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[206] Mark W. Olson, "The Monetary Control Act, 30 Years Later: Congress Once Again Debates Financial Reform, but the Granddaddy of Modern Omnibus Banking Bills, Passed in 1980, Remade Much of the Industry," *ABA Banking Journal* Vol. 102, No. 3, (March 2010): 5-7.

[207] Edward F. Smith, "Bankers Take Aim Against Money Funds," *ABA Banking Journal* 72, no. 3 (March 1980): 4.

[208] Edward F. Smith, "How Competition, Inflation, and Monetary Policy Shaped New Law," *ABA Banking Journal* 72, no. 5, (May 1980): 8.

The federal banking regulators supported the bankers' efforts to deregulate interest rates, but not just to ensure that banks remained competitive in the difficult market conditions. There was an additional factor in play caused by the reserve requirements imposed by the Federal Reserve. Recall that as a consequence of the dual-charter feature of the U.S. banking system, not all banks were required to maintain the same capital reserves. While all FDIC insured banks had to maintain reserves, those that were Federal Reserve members had the highest requirement, state-chartered member banks somewhat less, and nonmember banks the lowest requirements of all. Mark Olson, future Federal Reserve Governor but at the time president of Security State Bank in Minnesota, estimated that over the course of a year the reserve requirements "would cost a member bank with $100 million of net demand deposits almost $1 million more than a typical nonmember bank of similar size."[209]

Federal Reserve Chairman G. William Miller expressed concerned that large regional and community member state banks were dropping their Federal Reserve membership to improve competitive position by reducing their reserve requirement. Even some national banks were considering shifting their charters. While this would of course undermine the Fed's position among its peers at the OCC and FDIC, it had a broader policy implication. That is, if a sufficient number of banks were to adopt state charters and so reduce their reserves it would undermine the Federal Reserve's ability to implement monetary policy. As a result, Miller recommended the adoption of "universal and uniform but lower reserve requirements focused on transaction accounts." This plan was supported by the FDIC as a way to ensure sufficient reserves were available to

[209] Olson, "The Monetary Control Act," 5-7.

protect bank solvency, and endorsed by the ABA in January 1979. On the other hand, small bankers remained reluctant to support Miller's plan as the price of interest rate relief. Their pushback led Miller to endorse a reduction in the requirement for smaller banks along with a phase-in of the new reserve rules in order to win them over.[210]

Bowing to pressure from bankers and their federal regulators, Congress passed and President Carter signed the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) on 31 March 1980. Among other changes, DIDMCA initiated a phase out of Regulation Q interest rate ceilings over six years; overrode certain state usury ceilings related to bank loans; phased-in reduced capital reserve requirements; and increased FDIC deposit insurance from $40,000 to $100,0000. DIDMCA also allowed banks to offer NOW accounts and, in a move that would have serious policy consequences for the S&L crisis, expanded lending authority for savings and loan institutions.[211] More to the point, DIDMCA represented the first legislative defeat for the New Deal-era banking regulatory structure by eliminating interest rate controls as one of the pillars of Glass-Steagall.

DIDMCA immediately had noticeable effects. For one thing, the exodus of member banks from the Federal Reserve halted. However, the S&L crises and to a lesser extent the banking failures continued. These on-going failures were primarily driven by the Regulation Q restrictions being lifted faster than the lending rate restrictions, which kept the depository institutions in a precarious financial position. Banks were slightly

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[210] Smith, " Monetary Policy Shaped New Law," 8.

[211] Depository Institutions Deregulation and Monetary Control Act of 1980, PL-96-221, enacted 31 March 1980.

better off in this regard than the thrifts because the S&L loan portfolios were so heavily weighted to mortgages, which were long-term assets.[212]

One final change regarding interest rate regulation occurred after the passage of DIDMCA. The new Reagan administration, and especially FHLBB chairman Richard T. Pratt, actively advocated additional deregulatory steps in banking, including the accelerated removal of interest rate controls. As a result of urging by the S&L industry leadership and administration support, Congress undertook consideration of additional financial deregulation. With the Senate now under Republican leadership, Senate Banking Chairman Jake Garn, R-UT, called for extensive deregulation across the banking and thrift industries, to include merging the FSLIC and FDIC to eliminate a layer of federal oversight. However, the House remained under Democratic control, and House Banking Committee Chairman Ferdinand St. Germain, D-RI, insisted on a narrower bill to simply bail out ailing thrifts.[213]

Negotiations among Garn, St. Germain, and Pratt were contentious, but ultimately the continuing S&L crisis forced their hands. Congress passed the Garn-St. Germain Depository Institution Act of 1982 (GSG), and President Reagan signed in October of 1982.[214] Relative to the business of banking the primary outcome of GSG was to accelerate the complete removal of Regulation Q interest rate restrictions to 1984, or two years sooner than required by DIDMCA. GSG also permitted all depository institutions to offer insured money market mutual funds, broaden the use of adjustable rate

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[212] White, *The S&L Debacle*, 72-74.

[213] Mason, *From Buildings and Loans to Bailouts*, 220-221. United States League of Local Building and Loan Associations (League) executive William O'Connell claimed that Garn St. Germain, "wouldn't have happened without trade group support."

[214] Garn–St Germain Depository Institutions Act of 1982, PL. 97–320, enacted October 15, 1982.

mortgages, and authorized NOW accounts without interest rate caps. Interestingly, the most significant provision of GSG backfired. In order help stabilize the S&L industry, the law permitted S&Ls to expand commercial lending well beyond the traditional mortgage lending portfolios. From the perspective of bankers this step created additional competition. Unfortunately, it also allowed unscrupulous or inexperienced S&L owners to recklessly lend in areas for which they had little experience. The result was that GSG addressed neither the banking nor S&L crises effectively.[215]

The net effect of banking deregulation in the 1980s was an overall relaxation of regulatory supervision over banks and thrifts, thus freeing them to compete on interest rates and concomitantly encouraging them to take on riskier loans to support those rates. And to the extent that the interest rate restrictions were at the heart of the Depression-era regulatory framework, their removal opened the door to consideration of repealing other aspects of the New Deal financial structure.

Launching the Modern Campaign for Legislative Repeal of Glass-Steagall

In parallel with removing interest rate restrictions, there was an isolated legislative effort during the 1980s to repeal Glass-Steagall requirements for the separation of banking, securities, and insurance. Leaders in the banking community, particularly of the largest banks, argued that both Glass-Steagall and the Bank Holding Company Act, as amended, were outdated and in need of reform. That is, they contended that the Depression-era paradigm, built as it was on the notion of minimizing risk to depositors, no longer applied in the contemporary economic environment for banking.

[215] Spong, *Banking Regulation,* 28-31; Mason, *From Buildings and Loans to Bailouts*, 219, 244. Although it had little to do with the banking industry, the S&L crisis was finally resolved by the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

The ABA's position was that investment diversification would better safeguard customer deposits rather than put them at greater risk. George Cleland, editor of the *ABA Bankers Journal*, argued, "Many banks already engage in high-risk marketplaces (e.g., energy, agriculture, and real estate lending). In fact, banks would benefit from new product and service opportunities such as underwriting securities."[216]

Legislative repeal efforts for Glass-Steagall came to the fore in the late 1980s through bipartisan support by Senate Finance Committee Chairman William Proxmire, D-WI, and ranking minority member Senator Jake Garn, R-UT.[217] Their proposed bill, supported by the banking trade associations and known as the Financial Modernization Act of 1988 (S.1886), was an inflection point in that Congressional leaders were willing for the first time to undertake a serious look at repeal. No friend of big banking, Proxmire's principled support for reform added substantial credibility to the effort. Although ultimately unsuccessful in repealing Glass-Steagall the legislative debate clarified the positions of the financial services industry and the regulatory community.[218]

Bank regulators began to push the narrative that modern banking conditions in the 1980s were fundamentally different from what they had been during the Great Depression, when the underlying regulatory structure for banks was established. This approach evolved over time, as the views of key banking regulators began to reflect the changing ideological consensus, referenced earlier, that the original premise of the Glass-

[216] George Cleland, "Black Monday and Bank Reform Should Not be Linked," *ABA Banking Journal* Vol. 80, No.1, *January* 1988: 7.

[217] The Democratic Party won control of the U.S. Senate in the 1986 elections.

[218] Raymond Natter, Interview, February 22, 2017. Natter, former counsel of the Senate Banking Committee (1987-1994) and later deputy counsel for the OCC, said: "I like to point to the 1988 Financial Modernization Act because it was almost exactly what eventually passed, but it was a Proxmire bill." His point being that Proxmire was a reformer and could in no way be considered coopted by the banking industry.

Steagall Act was incorrect.[219] For example, both Comptroller Robert L. Clarke and FDIC Chairman L. William Seidman testified to the House Banking Committee that the problems of the Great Depression were unrelated to banks being in the securities business. Additionally, Clarke and Seidman argued that in 1988, in comparison to the 1930s, banks were required by bank examiners to hold a far higher capital reserves. Moreover, in their view the financial services industry of the 1980s benefitted from the regulatory oversight of two additional regulatory agencies - the SEC and FDIC - that were specifically created by the New Deal banking reforms. [220]

Other pro-reform officials also argued that Federal Reserve policymakers now understood crashes better, as they had demonstrated by increasing liquidity during the recent 1987 market crash in comparison to 1929 when the Federal Reserve Board erroneously tightened credit. Finally bank examiners asserted there was a broader safety net in 1988, including social security and agricultural price supports, which flattened out the business cycle and decreased the likelihood of another Great Depression.[221]

Banking regulators contended that Congress should not allow the emotions evoked by the recent 1987 stock market crash to affect their willingness to pass the Proxmire bill despite comparisons to the Crash of 1929. Indeed, Federal Reserve Chairman Alan Greenspan and others consistently argued that the banking regulatory structure reform should come by legislative action rather than regulatory fiat. As Greenspan remarked, “Developments have significantly eroded the ability of the present

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[219] Benston, *The Separation of Commercial and Investment Banking;* White, “Before the Glass-Steagall Act,” 33–55.

[220] Cleland, “Banking Reform is Critical,” 51; Mark Olson, "H.R. 10: Same Song, New Verse," *Ernst & Young Insurance Executive,* Spring 1999.

[221] Olson, "Same Song, New Verse," Spring 1999.

structure to sustain competition and safe and sound financial institutions…It is essential that Congress put in place a new, more flexible framework."[222]

The support of regulators for repeal of Glass-Steagall was not advocacy for the removal of all constraints or creating entirely free markets. Instead, both Seidman and Clarke argued that any modernization of banking laws must be accompanied by strict regulatory oversight. In Seidman's view, "A supervisory wall can be created. The FDIC…has provided effective supervision of the relationship between the parent holding company, affiliated banks, and the parent's nonbank subsidiaries." While Clarke similarly observed that, "A safe yet competitive marketplace can be achieved through the use of the existing network of safeguards, coupled with additional measures." In other words, the bank regulators were willing to undertake deregulation, but advocated retention of the same basic regulatory structure.[223]

In the end, the federal banking regulators and large commercial banks were only partially successful in persuading Congress to repeal Glass-Steagall. The Senate passed Proxmire's bill in 1988 to repeal portions of the Glass-Steagall Act. It allowed banks to participate in securities activities while restricting their insurance activities. The House Banking and Finance Committee and House Commerce Committee each approved a similar bill but the full House was unable to pass a bill.[224]

The failure in the House reflected the inability of the Banking and Commerce Committees to resolve jurisdictional issues between themselves. The House Commerce

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[222] George Cleland, "Main Event Continues as ABA Wins Three Bouts," *ABA Banking Journal*, March 1988: 7.

[223] Cleland, "Banking Reform is Critical," 51.

[224] Michael F. Crotty, "Insurance Borders Remain Hazy," *ABA Banking Journal* 80, No. 4, April 1988: 78-82.

Committee was particularly sensitive to the impact on the securities industry, which opposed the bill. Edward I. O'Brien, President of the Securities Industry Association (SIA) argued that the Proxmire bill would put banks and their customers' money at risk. In addition, the banking committees made the mistake of including several consumer protection measures in their bills. Large commercial banks lobbied against those provisions as unnecessary and an administrative burden. Small banks also adamantly opposed new consumer protection measures in the various Glass-Steagall repeal bills. The lobbyists for community bankers argued that they would see little benefit from deregulation and that such measures would decrease the small banks' ability to compete against large banks. For small banks, adding consumer protection measures to the mix only increased that burden.[225]

Hence in the face of jurisdictional issues, opposed by the securities industry, and lacking unified support from the commercial banking industry, the House was unable to follow the Senate's lead. Once again efforts to repeal Glass-Steagall were postponed. One unanticipated consequence of this failure was the bad blood created between the Senate and House Banking Committees over Glass-Steagall repeal. Having taken the political risk of repeal only to have the House fail to follow through in 1988, the Senate Banking Committee refused thereafter, through the1990s, to act on Glass Steagall repeal until the House passed a bill first.[226]

The failure of the Proxmire bill in 1988 established two patterns for the 1990s. First, congressional action on financial services modernization would be elusive until all

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[225] Cleland, "Black Monday and Bank Reform Should Not be Linked," 7.

[226] "Legislative Outlook: Banking (1988)," *CQ Weekly* (December 24, 1988): 3561–62; Cleland, "Main Event Continues, 7.

three of the industries came to a common agreement. Second, in the absence of Congressional legislation, bank supervisors took a broader interpretive view of the current laws, and in this they were increasingly supported by the courts. And Congressional action on Glass-Steagall repeal was unlikely in the near term, as both Henry B. Gonzalez, D-TX, and Senator Donald W. Riegle Jr., D-MI, the incoming chairs of the House Banking Committee and Senate Banking Committee respectively, indicated that in 1989 they would move on to other priorities.[227]

Indeed, banking reform was sidetracked for several years over the aftermath of the S&L bailout and the need to recapitalized the federal deposit insurance funds. In the former case, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) to create the Office of Thrift Supervision and establish the Resolution Trust Company (RTC) to close hundreds of failed thrifts. While FIRREA also included a mandate that required the Bush Administration to propose a roadmap to banking modernization, the resulting effort produced neither legislative or nor regulatory changes.[228]

The next serious attempt at banking reform legislation, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), was also driven primarily by the dying gasps of the S&L crisis. At the time, the FDIC had exhausted its deposit insurance funds and required an injection of $30B from Treasury in order to cover the

[227] Steve Cocheo, "Of Maps and Men," 8-9.

[228] Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), PL 101-73, 103 Stat. 183. FIRREA also had the following additional provisions: abolished the Federal Home Loan Bank Board and replaced it with the Federal Housing Finance Board, which was designated to oversee the twelve Federal Home Loan Banks; replaced the FSLIC with the Savings Association Insurance fund, to be administered by the FDIC; permitted holding companies to acquire thrifts.

losses from bank failures.[229] Sensing an opportunity in "must pass" legislation for the deposit insurance bailout, the Bush Administration attempted to insert broader banking reform measures, such as interstate banking and a narrowing of bank insurance sales powers. However, these reform efforts were rejected by Congress in the face of both interest group pressure and a lack of consensus among the members and between the House and Senate on how to proceed. Instead, Congress passed the much more narrowly focused FDICIA to fund both the federal thrift and banking deposit insurance funds as well as to incorporate additional safety and soundness features for bank oversight.[230]

Hence it became apparent that both bankers and bank regulators needed to continue their sequential approach to improve the competitiveness of U.S. banking through deregulation. As the OCC and Federal Reserve in particular turned to administrative approval of bank expansion into securities and insurance, Congress began to address geographic restraints.[231]

Dismantling Geographic Constraints

Given the lack of consensus on comprehensive banking reform under Chairmen Gonzalez and Riegle, both banking groups and federal regulators began to target the

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[229] Eugene N. White, "The Legacy of Deposit Insurance: The Growth, Spread, and Cost of Insuring Financial Intermediaries," NBER Working Paper Series, No. 6063 (Cambridge, MA: NBER, 1997), 31; Macey, Miller, and Carnell, *Banking Law and Regulation*, 37. The salient features of the FDICIA were as follows: replenished the banking and thrift deposit insurance funds; increased ability of the FDIC to borrow from the Treasury, creating greater reserves; FDIC requirements to set risk-based deposit insurance premiums (implementing the Basel I international agreement in the U.S.); an attempt to curtail the "too big to fail" syndrome (e.g., by using insurance to protect uninsured types of accounts); and creation of a system of "prompt corrective action," which imposed more bank restrictions and requirements (e.g., no dividend payments) as capital declined below required levels.

[230] "Session Wrap-up: Economics and Finance," *CQ Weekly* (December 7, 1991): 3566–74. See also Appendix 1.

[231] "Session Wrap-up: Economics and Finance," *CQ Weekly* (December 7, 1991): 3566–74. See also Appendix 1.

removal of geographic restrictions on commercial banking in the U.S. in the period 1992-1994. These efforts culminated in the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 authorizing interstate banking. Riegle-Neal was a significant accomplishment in banking reform, but also one that left little energy for any contemporary effort to repeal Glass-Steagall.[232]

Just to review, the U.S. banking system had geographic restrictions on banking and bank branches that preceded the New Deal regulatory structure but were codified by it. As discussed under "Banking Failures" above, over the course of the late 20th century business inefficiencies inherent in geographic restraints became more difficult for banks to sustain in the face of changing market conditions such as competition from nonbank banks, foreign banks, and the securities and insurance industries.

The banking industry actively pursued work-arounds to the interstate banking restrictions in the expectation of efficiency and improved profit margins. Some approaches involved alternative banking arrangements, as when Citibank used its single-bank holding company status to purchase S&Ls in multiple states.[233] The banking industry also leveraged significant advances in technology to enable widespread banking operations. For example, advances in data processing were used in centralized ledgers, deposit systems, loan processing times, and securitized products to improve the efficiency of decentralized banking.[234]

[232] Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, PL-103, 328 enacted 29 September 1994.

[233] This is just one example of early aggressive Citibank tactics that foreshadowed the Citicorp-Travelers merger in 1998.

[234] Tom Coyle and Mary Dixon, "ACB to Implement Strategic Plan," *America's Community Banker* 8, no. 10 (October 1999): 10.

Technological advances were also important in changing customer demands on the banking industry. Most importantly, the advent of Automatic Teller Machines (ATM) technology posed significant challenge to unit banking, or state banks with no branches. Once customers realized what the ATM could deliver, they demanded of their banks additional convenience in terms of hours and multiple locations. As a result, many state legislatures liberalized unit-banking rules to permit banks to operate remote ATMs, and these linked ATM networks had the effect of undermining the rational for intrastate restrictions on branching.[235]

Bankers also incrementally challenged the ban on interstate banking through regional bank compacts (RBCs), or agreements among adjacent states to a common approach to banking regulation. The first RBC was established in New England in 1984. The Supreme Court upheld the Board's approval of RBCs, which allowed banks to acquire other banks out of state but within a region if the relevant states had passed laws permitting such acquisitions.[236] In many ways, the RBCs reflected the intention of the medium-sized regional banks to counter the financial clout of the financial centers in New York, California, and Illinois. These regional powerhouses eventually became the major players in the interstate movement. While not all states permitted acquisitions of local banks by BHCs, or joined other states in an RBC, enough did that it established a

[235] Spong, *Banking Regulation*, 41-45. This process continued with the advent of the Internet and the evolution of online banking.

[236] *Northeast Bancorp, Inc. v. Board of Governors*, FRS, 472 US 159 - Supreme Court 1985

clear trend. By 1988, all states but six had some form law in support of interstate banking.[237]

Despite the efficiencies gained with new technologies and the success of work-arounds to the federal limitations such as RBCs, the system of geographic restrictions remained cumbersome. Large commercial bankers actively lobbied Congress to use legislation to explicitly remove the McFadden Act and Douglas Amendment to the BHCA from federal law. The ABA typically argued that eliminating geographic restriction on U.S. banking would have the advantage of improving the overall competitiveness and efficiency of the banking sector.[238] Indeed, banking lobbyists argued that enhancing the competitiveness of commercial banks was necessary to counter domestic financial companies, new products from the securities and insurance industries, and foreign banks from encroaching into the business of commercial banking.[239]

Federal bank regulators generally agreed with the commercial banking community. As former FDIC Chairman William Isaac pointed out, the U.S. banking system's eroding competitiveness was a fundamental risk to the U.S. economy that warranted the removal of geographic restrictions.[240] Additionally, FDIC officials at the time saw geographic diversity as one way to reduce the burden of any localized downturn

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[237] Macey, Miller, and Carnell, *Banking Law and Regulation*, 32. The holdout states were Arkansas, Hawaii, Iowa, Kansas, Montana, and North Dakota.

[238] "Banking Issues," *Congressional Digest* 71, No. 1 (January 1992): 7.

[239] P. Mulloy and C. Lasker, "The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Responding to Global Competition," Journal of Legislation, 1995.

[240] Kenneth H. Bacon, "The End of Banking as We Know It – Losing Ground: Banks' Declining Role in Economy Worries Fed, May Hurt Firms, "Wall Street Journal, July 9, 1993.

on deposit insurance funds as a bank with branches would be expected to be more resilient than a unitary bank.[241]

In opposition, smaller community bankers historically argued that the banking system in the U.S. would be stronger with geographic diversity that prevented undue concentration of banking in the hands of relative few large banks. As Jim Faris, President of the Conference of State Bank Supervisors (CSBS), testified to Congress in the 1970s, the dual banking system promoted virtuous competition and innovation.[242] This argument was raised again in the Riegle-Neal debates. According to Chris Lewis, Director of Banking and Housing policy at the Consumer Federation of America, some small bankers objected that removing geographic restrictions would lead to undue concentration in banking with large banks and their branches crowding out community banks.[243]

Despite the historical arguments, small bankers' opposition to Riegle-Neal was surprisingly muted. This was driven partially by a trend of cooperation and trust that had been built between the ABA and the various state bankers associations over the shared and successful opposition to the moratorium on new banking products imposed by Congress in 1987.[244] In the case of geographic restrictions, large bankers reached out via

[241] S. Stritzel, "The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994: Progress Toward A New Era in Financial Services Regulation," Syracuse Law Review, 1995.

[242] James E. Faris, "*FINE Study Discussion Principles*," Testimony on behalf of the Conference of State Bank Supervisors before the Subcommittee on Financial Institutions Supervision, Regulation, and Insurance of the Committee on Banking, Currency, and Housing, U.S. House of Representatives. Library of Congress, *The J.L. Robertson Papers*, Box 13. Washington, D.C., December 16, 1975.

[243] Chris Lewis, Hearings on Interstate Banking and Branching Before the Subcommittee on Financial Institutions Supervision, Regulation and Deposit Insurance, 103d Cong., 2d Sess. 91 (July 29, 1993).

[244] George Cleland, "The Real Victory Banks Won March," *ABA Banking Journal* Vol. 80, No. 5, May 1988, 9. In 1987, Congress imposed a moratorium on new banking

the ABA to offer concessions to small bankers to make the seemingly inevitable reforms more palatable. Bill Medley, historian for the Federal Reserve Bank of Kansas City, claims trade associations for the small bankers such as the ACB and the IBAA were able to negotiate terms that allowed community banks to opt out of Riegle-Neal, limit territorial expansion from out of state to the acquisition of existing banks in state, and impose a five-year age requirement on banks before they could be acquired.[245]

Small bankers were also simply less concerned about losing out to large banks than they were only a decade prior to Riegle-Neal. As Paul A. Schosberg, President of ACB pointed out retrospectively, the same new technologies that enabled large banks to operate nationally also enabled community banks to improve services and increase efficiency.[246] Indeed, community bankers had proven through the advent of RBCs that well capitalized and managed community banks could leverage the new information technologies to compete effectively across state lines. Finally, Robert Forrestal, President of the Federal Reserve Bank of Atlanta, argued that the empirical data from states with large intrastate branching structures such as California and New York demonstrated that large banks would not crowd out community banks.[247]

The changing market conditions, advent of new technologies, advocacy by large commercial bankers, support from federal regulators, and acceptance by community

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securities products in the Competitive Equality Banking Act (CEBA), which also closed the nonbank bank loophole.

[245] Ken Medley, "Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 | Federal Reserve History." Accessed August 6, 2018. https://www.federalreservehistory.org/essays/riegle_neal_act_of_1994.

[246] Coyle and Dixon, "ACB to Implement Strategic Plan,"10.

[247] Robert P. Forrestal, "Financial Services Industry Restructuring," Remarks to the Community Bankers Association of Georgia, Lake Buena Vista, Florida, September 17, 1991.

bankers all combined for a compelling case to eliminate geographic restrictions on branching and interstate banking. Finally, in 1994, Congress passed the Riegle-Neal Interstate Banking and Branch Efficiency Act over a decade after the market began to signal the need to eliminate geographic restrictions. Riegle-Neal allowed bank holding companies to acquire banks in any state as well as open branches in new states. This law in effect repealed both the McFadden Act and the Douglas Amendment to the Bank Holding Company Act. Riegle-Neal also explicitly authorized the Federal Reserve to permit an adequately capitalized and managed BHC to acquire banks nationwide even if there was a local or state law prohibiting such an acquisition. Having acquired a local bank, BHCs could then merge the acquired bank, effectively creating branches.[248]

The elimination of geographic restrictions led to significant consolidation within the banking industry.[249] The trend was clear. Overall, the total number of banking institutions fell by 18.4% over the five years ending Dec. 31, 1997. Not surprisingly, as the number of banks declined the assets held per institution increased. More specifically, as the number banks fell to 7,233 in 1997 from 8,868 in 1994 and total assets held by those organizations rose by 43.37%.[250]

To provide some examples of this process, NationsBank bought Boatman's Bancshares in 1996, and then Barnett Bank in 1997 to become the biggest bank holding company in the country. After Bank of America bought Security Pacific in 1992, NationsBank then bought Bank of America in 1998. In parallel, the merger of three of the

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[248] At the time, only Montana had a law prohibiting such mergers. Foreign banks were given the same rights as national banks.

[249] Spong, *Banking Regulation,* 32-33.

[250] Steve Cocheo, "One in Five Banks Disappear over Five Years," *ABA Banking Journal* 90, No. 8, August 1998: 7. Data gleaned from a study conducted by SNL Securities' Bank Investor magazine.

largest New England banks created Fleet Boston. Finally, in 2004 the new Bank of America bought Fleet Boston. Similarly, JPMorgan Chase was the product of mergers between Chemical Bank and Manufacturers Hanover in 1991, First Chicago and National Bank of Detroit in 1995, Chemical and Chase Manhattan one year later, Bank One and First Chicago in 1998, then JP Morgan and Chase Manhattan in 2000, and finally JPMorgan Chase and Bank One in 2004.[251]

Each large bank to bank merger was in its own way a seminal event. For example, the announcement of the merger between BankAmerica and NationsBank was in fact the creation of the first truly coast to coast bank. Only 20 years previously such an interstate banking institution was inconceivable, but this was the logical end result of Riegle-Neal.[252] Such major mergers were prelude to the merger of Citicorp and the Travelers, which was the most significant financial institution merger of the 1990s.

1995-1996 and Republican Control

Having completed repeal of interest rate controls and the geographic restrictions on banking, Congress once again turned to legislative repeal of the Glass-Steagall requirements to separate banking, securities, and insurance. The Republicans won control of both the House and Senate in the 1994 elections. This ultimately was to play a significant role in Glass-Steagall repeal, but the immediate impact was less apparent as the new party leaders and committee chairmen began to find their way.

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[251] Simon Johnson and Kwak, James, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown* (New York: Pantheon, 2010), 83-86; Cocheo, "One in Five," 7. Similar stories could be told about the growth of many others large banks, including Wells Fargo and Wachovia.

[252] Steve Cocheo, "Of Maps and Men," 7.

In 1995, the House Banking Committee under new Chairman James Leach, R-IA and the House Commerce Committee under new Chairman Thomas Bliley, R-VA both undertook to write bills that repealed portions of Glass-Steagall. There was little traction, as Leach and Bliley were unable to reconcile the competing provisions of the two bills. And neither the House Banking nor Commerce Committee bills independently saw floor action in the House due to bank opposition to the insurance provisions.[253] Similarly, in 1996 the various Glass-Steagall repeal bills from 1995 were redrafted in an effort to find a compromise, but each version was opposed by banks because they would not allow banks to sell insurance. In the end, none of the 1996 draft versions were brought to a floor vote.[254]

As regards Glass-Steagall repeal, the 104th Congress demonstrated that the banking, securities, and insurance industries were only interested in legislative action that would protect their current positions by preventing additional competition. The major point of contention was between the banking and insurance industries over the sale of insurance in banks. Banks sought to continue to do so by gaining favorable regulatory approvals from bank examiners. Insurance trade associations fought in court and Congress to prevent and roll back regulatory approvals for banks to enter the insurance business. At the least, insurance lobbyists sought to ensure that any bank insurance sales were subject to the same licensing requirements and state commissioner oversight that insurance agents faced.

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[253] "Status of Major Legislation," *CQ Weekly* (December 9, 1995): 3770–72.

[254] Lantie Ferguson, "Decades of Efforts to Change the Glass-Steagall Act," *CQ Weekly* (October 23, 1999): 2505.

Congress accomplished little in terms of repealing Glass-Steagall in this interim period from 1994-1996. Unlike interest rate and geographic restrictions, which were matters between the bankers and their regulators, the separation of the financial services industries from banking had a broader impact on the interests of the securities and insurance industries. Not surprisingly, those industries were both motivated and had the means to fight repeal of Glass-Steagall in Congress. In fact, it became apparent to the bankers, broker-dealers, and insurers alike that little progress was to be made in Congress on repealing Glass-Steagall until all sides could come to a compromise agreement. That left a regulatory and judicial campaign as the only viable option.

Breaking Down the Glass-Steagall Barriers

Within a given repeal effort, such as a decision to challenge Glass-Steagall restrictions on the affiliation of commercial banking, securities, and insurance, the tactical approaches to deregulation taken by financial industry lobbyists and interest groups had to account for the fragmented policy process. In other words, despite banking industry interest in repealing Glass-Steagall contemporaneously with removing interest rate and geographic restrictions, a legislative repeal by Congress was unlikely absent either a crisis as with high interest rates and disintermediation, or a long-term campaign to build support as happened with geographic restrictions.

This strength of Congressional support for the status quo led the commercial banking industry trade association leadership to develop a regulatory and judicial campaign to overturn Glass-Steagall. This approach was explicitly recognized within the industry. Ed Yingling, the chief lobbyist of the American Bankers Association (ABA), once said, “More broadly, for years we had our strategy of going to the agencies every chance we got, going to the courts, going to the state legislatures to get changes. We always thought Congress would come later."[255]

It is worth underscoring at this point that the tactical decision to focus on regulatory and judicial approval within the current regulatory structure privileged the power and authority of the regulatory agencies for the financial services industries. The failure of Congress to act granted these banking regulators, such as Federal Reserve Chair Greenspan, Comptroller Ludwig, and FDIC Chairwoman Ricki Helfer agency to control the pace of breaking down Glass-Steagall barriers. Additionally, it provided the federal bank examiners a significant voice in Congressional debates about how to shape the eventual legislative repeal because of the expertise they developed and maintained on banking regulation.[256] While the regulatory and judicial campaign ultimately prompted Congress to act, it also established precedent that made it less likely Congress would undercut the regulatory structure when it passed deregulatory legislation.

Federal Reserve Section 20 Exceptions

One of the major factors that eventually brought repeal of the Glass-Stegall framework's separation of banking, securities, and insurance was an on-going regulatory repeal of the original legislative provisions. The large commercial bankers and the ABA began to actively seek exceptions to be granted by the federal banking supervisors.[257] The

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[255] Edward Yingling, "The Making of a Law," *ABA Banking Journal* 91, No.12, December 1999: 20-24.

[256] Zelizer, *Taxing America,* 179-208 discusses the role of bureaucratic expertise in the tax policy community and the power it granted the regulatory state in shaping legislative outcomes.

[257] Donald G. Ogilvie, "Financial modernization: 20 Years in the Making," *ABA Banking Journal* 91, No. 12, December 1999: 7. As Ogilvie said, "In fact, financial modernization was already an ancient topic when I arrived at the ABA in 1985. We had long since accepted that Carter Glass and Henry Steagall went too far in separating commercial banking, investment banking, and insurance. We knew that bankers urgently

Federal Reserve in particular began to issue rulings to allow commercial banks operating within BHCs to expand into the securities business. One need only recall that the Federal Reserve had regulatory oversight of all bank holding companies, which controlled 96% of banking assets, to understand the significance of this policy shift on the part of the Federal Reserve.[258]

In an important precedent set in 1978, the Federal Reserve ruled that Bankers Trust did not violate Glass-Steagall when it began placing commercial paper issued by corporations with investors. This and similar rulings, which the Federal Reserve contended were simply a clarification of vague wording in Section 20 of the Glass-Steagall Act, allowed commercial banks to set up affiliated companies through a common bank holding company in order to deal in specific securities that were off-limits to commercial banks. As a result, institutions making use of these exceptions were labeled "Section 20" affiliates.[259]

On a related note, there was a specific reason why the Federal Reserve's Section 20 exceptions were focused on banks engaging in securities activities within a holding company structure, but not insurance. The simple fact of the matter was that the Federal Reserve policymakers had less room for interpretation as regards the encroachment of banking into insurance. With securities, the Board was generally exercising their authority to regulate holding companies under the BHCA of 1956 as amended in 1970. A

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needed new competitive tools to serve their customers." He continued: "We knew what had to be done. We believed we could do it. We had no idea it would take so long."

[258] Simon Kwan, "Cracking the Glass-Steagall Barriers," *Federal Reserve Bank of San Francisco Economic Letter* 97-08 (San Francisco: Federal Reserve Bank of San Francisco, March 21, 1997.)

[259] This regulatory ruling was ultimately upheld by the DC Circuit Court of Appeals in *Securities Industry Association vs. Board of Governors of the Federal Reserve System,* 807 F.2d 1052 (D.C. Cir. 1986). See also Appendices 1 and 2.

lesser known amendment to the BHCA occurred in 1982 related to banking and insurance within a holding company structure. Specifically, Title VI of the Gain-St. Germain Act amended the BHC Act to prohibit bank holding companies from engaging in, or being affiliated with a company engaged in, insurance underwriting or agency activities, with certain limited exceptions.[260]

Returning to the Section 20 exceptions, in 1986, again at the request of Banker's Trust, the Federal Reserve declared that the Glass-Steagall framework allowed commercial banks to underwrite mortgage backed securities, commercial bonds, and other investment banking activities as long as such activities were limited to 5% of their total portfolios. Despite efforts by securities broker dealers to fight the Federal Reserve on this issue, seen especially in court actions brought by the Securities Industry Association (SIA), the courts eventually sided with the Federal Reserve.[261]

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[260] 12 U.S.C. § 1843(c)(8), the Gain-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (1982).

[261] *Securities Industry Assn. v. Board of Governors*, FRS, 468 US 137 - Supreme Court 1984. In *SIA v. Board* (1984) the Supreme Court disagreed with the Federal Reserve, holding that commercial paper was a security, but approved the placing commercial paper by banks as long as they did not underwrite the commercial paper. *Securities Industry Association v. Board of Governors* 839 F. 2d.47 (2d Cir. 1988). In *Securities Industry Association v. Board of Governors* 486 U.S. 1059 (1988) the Supreme Court denied certiorari in this case. Also, in *Securities Industry Association v. Board of Governors* 847 F.2d 890 (D.C. Cir. 1988), the D.C. Court of Appeals upheld a similar Board approval for Chase Manhattan, accepting the Second Circuit's logic. The Federal Reserve established 'firewalls" to ensure the affiliate was not "engaged principally" in securities, including: 1) revenue restrictions (first 5% then 10% after 1989) on the Section 20 affiliate's bank-ineligible securities underwriting and dealing; 2) capital adequacy requirements for both the section 20 subsidiaries and the BHC itself to ensure the BHC will not risk capital necessary to support is subsidiary banks; 3) prohibited financial ties between federally insured banks and their section 20 affiliates in order to protect the federal safety net; 4) corporate separateness to insulate subsidiary banks both operationally and structurally from Section 20 affiliates.

The Supreme Court set the tone with *Securities Industry Association vs. Board of Governors of the Federal Reserve System* (*SIA v. Board*) in 1988. This case marked the Supreme Court's acceptance of the Federal Reserve's logic in approving Section 20 affiliates. That is, the Federal Reserve was now free to approve bank holding company subsidiaries that could underwrite and deal in municipal revenue bonds, mortgage-backed securities, and third-party commercial paper as long as those Section 20 affiliates were not "principally engaged," in the business of securities.[262]

Reinforced by judicial decisions, the Federal Reserve continued to cautiously expand the number of Section 20 affiliates for bank holding companies, as well as the type of permissible activities, throughout the late 1980s to early 1990s.[263] In fact, it became the policy of the Federal Reserve to favor prudent expansion of Section 20 activities consistent with preserving the federal safety net and the safety and soundness of banks. In other words, the Federal Reserve Board's regulatory decisions made clear it collectively believed that until Congress acted the expansion of Section 20 affiliates made commercial banks more competitive. And, while repeal of Glass-Steagall was considered

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[262] *Securities Industry Assn. v. Board of Governors*, 839 F.2d. 47 – 2nd Circuit 1988; *Securities Industry Assn. v. Board of Governors,* 486 U.S. 1059 - Supreme Court 1988. Denied Certiorari, thus retaining 2nd Circuit decision. In 1987, the BHCs Citicorp, Bankers Trust, and JPMorgan all applied to the Board for permission to establish nonbank subsidiaries to underwrite and sell municipal revenue bonds, mortgage backed securities, and third-party commercial paper. The Securities Industry Association charged that an affiliate conducting these activities would be "engaged principally" in activities impermissible under Section 20. Notwithstanding the objection, the Board approved the applications, but established "firewalls," or restrictions to prevent the affiliate from being "engaged principally" in securities dealing.

[263] "Project: Regulatory Reform: A Survey of the Impact of Reregulation and Deregulation on Selected Industries and Sectors: Dismantling of the Glass-Steagall Act," *Administrative Law Review* 47, no. 4 (1995): 454-56. In Bankers Trust New York Corp., 75 Fed. Reserve Bull. 829 (1989), Bankers Trust's request was approved to engage in the private placement of all types of securities through its Section 20 affiliate.

preferable, the Board believed that it could provide effective oversight to ensure that the banks were not put at risk by the activities of the affiliates. As a result, by 1989 over 20 bank holding companies had been authorized to conduct Section 20 operations, and revenue from these activities rapidly progressed from $36 to $68 billion over the course of the year.[264]

Still, the expansion of Section 20 activities was unevenly distributed within the banking community. Smaller bank holding companies came to the realization that these activities were not profitable due to the cost of complying with the required firewalls. For example, the Federal Reserve could approve activities for the bank holding company, but not the bank itself. In order to comply with the regulatory firewalls between the BHC's subsidiary bank and its Section 20 affiliate for securities, the bank might be forced to transfer activities to the affiliate. This not only imposed cost to track the activity for regulators but was also inefficient. This difference explains why smaller and regional banks continued to oppose the repeal of Glass-Steagall during this period.[265]

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[264] Federal Reserve System, "12 CFR Part 225 [Regulation Y; Docket No. R-0958] Bank Holding Companies and Change in Bank Control (Regulation Y); Amendments to Restrictions in the Board's Section 20 Orders," Board of Governors of the Federal Reserve System, October 31, 1997, cf. footnote 2 in which the Board describes its own history of approving Section 20 affiliates: "See, e.g., J.P. Morgan & Co. Inc., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, and Security Pacific Corp., 75 Federal Reserve Bulletin 192 (1989) (hereafter, 1989 Order); Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp., 73 Federal Reserve Bulletin 473 (1987) (hereafter, 1987 Order); see also Canadian Imperial Bank of Commerce, The Royal Bank of Canada, Barclays PLC and Barclays Bank PLC, 76 Federal Reserve Bulletin 158 (1990) (applying earlier orders to section 20 subsidiaries of foreign banks) (hereafter, 1990 Order.)"

[265] Richard S. Simmons, "GAO Report: Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies," Hearings Before the Subcommittee on General Oversight and Investigations of the Committee on Banking, Finance and Urban Affairs, 101st Congress, 2d Session (May 1990): 329.

The story was different for the larger bank holding companies, which continued to lead the charge to loosen the Glass-Steagall restrictions. Able to leverage their corporate clients and knowledge of credit markets, these larger banks remained successful in their Section 20 operations. By 1993, four commercial banks (JPMorgan, Citibank, NationsBank, and Chase Manhattan) ranked in the top 15 underwriters of corporate debt, accounting for about 10% of the market share. JPMorgan was a case in point, holding 5.4% of the market by itself. So, overall, the data for determining the economic value of the Section 20 exceptions was mixed, but the large commercial banks continued to advocate strongly for bridging the gap between commercial and investment banking.[266]

Securities Exchange Commission Impotence

The securities industry was placed at a severe disadvantage in this on-going battle over the encroachment by bankers into underwriting and dealing in securities by the singular fact that the bankers were requesting accommodation from the banking regulators rather than the Securities Exchange Commission (SEC). It was not as if the SEC did not seek to intervene on behalf of the securities broker-dealers by attempting to regulate bank securities activities in the financial markets. In 1985, the SEC issued a rule that banks must register with the SEC if they entered the securities business. However,

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[266] U.S. General Accounting Office, "Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies," Report to the Chairman of the Subcommittee on General Oversight and Investigations, Committee on Banking, Finance and Urban Affairs, (1990): 34-35; Paul G. Hayeck, "The Profitability of Section 20 Subsidiaries, 12 *Annual Review Banking Law* 433 (1993): 429-433; Jeffrey Marshall, "Gold Rush of '93 Will Be Tough to Top," *U.S. Banker* (February 1994): 42; Ken B. Cyree, "The Erosion of the Glass–Steagall Act: Winners and Losers in the Banking Industry," *Journal of Economics and Business* 52, no. 4 (July 2000): 343–63; Anthony Saunders, "Banking and Commerce: An Overview of the Public Policy Issues," *Special Issue on Universal Banking and the Separation of Banking and Commerce* 18, no. 2 (January 1, 1994): 231–54.

the D.C. Circuit held that this rule exceeded the SEC's authority. That is, in the Securities Exchange Act of 1934 Congress explicitly "excluded banks from the rules governing brokers and dealers."[267] Similarly, in *Independent Ins. Agents of Am. v. Bd. of Governors* (1987) the Court of Appeals agreed with the Federal Reserve Board rulings that the SEC had no jurisdiction over bank security activities.[268]

The issue here was that the laws were written to allocate regulatory authority by institutional type, not function. So, courts could allow the Fed or OCC to decide what functions were permissible as "closely related to banking" because that authority was inherent in the legislative text. For example, in *SIA v. Board of Governors* (1986) the DC Circuit noted that the Board had "comprehensively addressed the language, history and purposes of the Act."[269] However, the courts could find no such authority in the Securities Act of 1934 for the SEC as a securities regulator to establish oversight of banking activities.[270]

Regardless, even after losing in court over the authority of the Board to approve Section 20 exceptions for bank holding companies, the broker dealers continued to object through the Securities Industry Association (SIA) to the specific authorities granted by the Federal Reserve to the newly empowered Section 20 subsidiaries of bank holding companies. For example, SIA representatives lobbied the SEC for increased enforcement

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[267] *American Bankers Association v. Securities Exchange Commission*, 804 F.2d 739 (D.C. Circuit 1986).

[268] *Independent Ins. Agents of Am. v. Bd. of Governors*, 835 F. 2d 1452 - Court of Appeals, Dist. of Columbia Circuit 1987.

[269] *SIA v. Board of Governors*, 807 F2d. 1052 (D.C. Cir. 1986) cert denied 483 U.S. 1005 (1987). The "Act" referred to here is the Glass Steagall Act. This opinion, written by Judge Robert Bork, demonstrates clearly that both the bankers and the Board of Governors of the Federal Reserve had learned over time and judicial opinions exactly how to make an argument that the Court could support.

[270] Markham, "Banking Regulation," 254-55.

actions against bank securities affiliates, citing 1994 and 1996 surveys by Prophet Market Research and Consulting to document the failure of bank affiliated sales representatives to inform customers that their securities investment would not be insured.[271] Noting the SEC's censure of a First Union Bank's securities sales team for deceptive practices, SIA leaders also argued that the firewalls specified by the Board were inadequate to protect either the federal safety net or the integrity of the securities markets. Additionally, they argued that the firewall between the subsidiary bank and Section 20 affiliate would not hold up in times of severe financial pressure.[272]

None of the SIA's pushback stopped the Board of Governors of the Federal Reserve from undermining the Glass-Steagall separation between commercial and investment banking throughout the 1990s. By 1996, the Federal Reserve was allowing bank holding company Section 20 subsidiaries to earn up to 25% of their revenues, up from the 10% originally authorized in 1986, from underwriting and selling securities.[273] As a practical matter, at this point the Glass-Steagall restrictions against the affiliation of securities and banking were in effect moot based on regulatory actions taken by the

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[271] Charles, Gasparino, "Fund Track: Banks are found Lacking in Mutual-Fund Disclosures," *Wall Street Journal*, Jan 16, 1996; Michelle Singletary, "Survey Faults Banks' Securities Marketing; Testers Often Not Told Funds Aren't Insured," Washington Post (Sept. 16, 1994): D1.

[272] Securities Industry Association, "GAO Report: Bank Powers: Activities of Securities Subsidiaries of Bank Holding Companies," Hearings Before the Subcommittee on General Oversight and Investigations of the Committee on Banking, Finance and Urban Affairs, 101st Congress, 2d Session (May 1990): 465. There was some evidence that the claim on failures during times of financial stress was correct, as in 1987 when Continental Illinois lent its nonbank affiliate over $90 million in violation of the Board's order.

[273] Charles R. Geisst, *Undue Influence: How the Wall Street Elite Put the Financial System at Risk* (Hoboken, NJ: John Wiley & Sons, 2005), 245-256. The actual regulation is published at "Revenue Limit on Bank-Ineligible Activities of Nonbank Subsidiaries of Bank Holding Companies Engaged in Underwriting and Dealing in Securities," 61 Fed. Reg. 68750 (1996).

Federal Reserve. However, Glass-Steagall remained in force and restrictions against affiliation between commercial banking and insurance still remained at the bank holding company level. [274]

OCC Actions and Part 5 Exceptions

As the consensus in support of Glass-Steagall restrictions eroded, the Treasury's Office of the Comptroller of Currency (OCC) also supported efforts to lift constraints on national banks, in much the same way the Federal Reserve eased restrictions on bank holding companies.[275]

The OCC continued to expand the permissible activities of national banks by reinterpreting "incidental powers" it was granted under the National Banking Act of 1864. From 1982 through 1994, Comptrollers Robert Clark and Eugene Ludwig successively issued a series of Interpretive Letters authorized operating subsidiaries of national banks certain activities denied to the banks themselves. For example, operating subsidiaries were authorized to underwrite securities for corporate bonds, municipal revenue bonds, and equity securities. The interpretations even variously classified certain financial products such as annuities as banking rather than insurance products so that banks could sell them.[276]

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[274] Richard S. Carnell, Jonathan R. Macey, and Geoffrey P. Miller, *The Law of Banking and Financial Institutions,* fourth edition (Austin: Wolters Kluwer Law & Business, 2009), 466-467.

[275] Hendrickson, "Glass-Steagall Reform", 849–79; Jin-Wook Choi, "The Limits on Regulatory Policymaking: The SEC and the Securities Market, 1930s--1990s," Ph.D., The University of Chicago, 2002.

[276] *Eligibility of Securities for Purchase, Dealing in Underwriting and Holding by National Banks; Rulings Issued by the Comptroller*, OCC, 47 Fed. Reg. 18,323 (Apr. 29, 1982); OCC Interpretative Letter No. 380 (Dec. 29, 1986); OCC Interpretative Letter No. 386 (June 10, 1987); OCC Interpretive Letter No. 652 (Sept. 13, 1994).

When these "incidental powers" interpretations were challenged, the Supreme Court deferred to the Comptroller's interpretation of its governing statutes. For example, the major objections came from the securities industry, which took Comptroller Clarke to court over his interpretation that the National Bank Act allowed a national bank to own a discount brokerage subsidiary. As with the Fed's Section 20 interpretations, the SIA argued that it was a violation of the Glass-Steagall Act for a bank to own a securities subsidiary. Consistent with its support of the Federal Reserve, the Supreme Court specifically reaffirmed in *Clarke v. SIA* (1987) that the principles of judicial deference to an agency's interpretation of its governing statute applied to the OCC interpreting the National Bank Act. In other words, the OCC was free to determine what activities were incidental to banking within the parameters of Glass-Steagall.[277]

Community and state-chartered banks also viewed the OCC's interpretation of national bank powers as a challenge to their own businesses. In particular, the Conference of State Banking Supervisors (CSBS) objected when the OCC allowed national banks to own subsidiaries that were in the securities business. Given that state-chartered banks in many states already had this authority, the CSBS' concern was not a matter of principle. Instead, their objection was that the OCC interpretation would undermine one of the few competitive advantages that community banks held over national banks.

However, the OCC continued to allow national banks to enter businesses formerly barred by Glass-Steagall while blocking individual state efforts to constrain them through state laws or judicial action. For example, in response to a California lawsuit over late fees on credit cards issued nationally by Citibank, Comptroller Ludwig issued 12 CFR

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[277] *Clarke v. Securities Indus. Ass'n,* 479 U.S. 388, 107 S.Ct. 750, 759, 93 L.Ed.2d 757 (1987).

§7.4001(a) in 1996 that treated credit card late fees as interest. In practical effect that allowed the bank issuing the credit card to be solely bound by the law of the issuing state, which meant in turn the large commercial banks could seek out the state with the most favorable banking climate such as North Dakota in this case.[278]

Finally, in 1996, Comptroller Ludwig announced that the OCC would modify Part 5 of the Code of Federal Regulations, "Operating Subsidiaries of a National Bank." This was a major policy step. The modified Part 5 would permit operating subsidiaries of national banks to gain expedited review to determine if proposed activities were permitted as either "part of" or "incidental to" the business of banking. For its part, the OCC relied on court interpretation of the Federal Reserve's Section 20 interpretations to argue that national banks and their subsidiaries were permitted a wider range of security and insurance activities than previously considered.[279]

Entering the 105th Congress, House Banking Committee Chairman Jim Leach noted with concern that the preemptory move by the Comptroller of the Currency in November 1996 to liberalize the OCC's interpretation of Part 5 of its regulation was not helpful to the legislative repeal process. Leach was not concerned with the substance of the Comptroller's planned regulatory update, which he thought could be beneficial by increasing competition. But he observed that the regulatory overreach might preempt more extensive and better-balanced legislation.[280]

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[278] Steven P. Croley, "Public Interested Regulation," *Florida State University Law Review* 28 (Fall 2000): 75-84. The Supreme Court ultimately upheld this regulatory policy in *Smiley v. Citibank (South Dakota), N.A.* US 735, 738 (1996).

[279] OCC Press Release NR 1996-129 dated November 20, 1996.

[280] Steve Cocheo, "Leach Offers Hints on Game Plan for New Congress: Calls OCC Gambit a Potential Monkey-wrench," *ABA Banking Journal* 89, No.1, January 1997: 7, 39-40.

It was clear that by 1996 the Federal Reserve and OCC had in effect undermined the entire Glass-Steagall regulatory framework. In other words, the OCC's Part 5 changes and interpretive letters were, along with the Section 20 approvals by the Federal Reserve, forcing the hand of Congress. At this point legislation was necessary to either rebuke the agencies for their expansive interpretations of bank powers, or legislatively codify the repeal of Glass-Steagall.

Bank Insurance Activities

The same judicial trend that occurred in commercial bank litigation with the securities industry also occurred with the insurance industry. The original basis for insurance sales by banks was a portion of the National Bank Act of 1916 that authorized a national bank to act as an agent for insurance companies. The law also left room for regulatory interpretation with a clause that grants to national banks "all such incidental powers as shall be necessary to carry on the business of banking."[281] The OCC expanded on this clause early on to reinterpret the authorization for banks to sell insurance in towns of less than 5000. Specifically, in 1971 the Comptroller William Camp issued 12 C.F.R. §7.7100 to clarify that "any branch of a national bank which is located in a town with less than 5,000 inhabitants, even though the principal office of the national bank may be in a town with a population greater than 5,000 persons" is authorized to sell insurance.[282]

In the 1980s, consistent with *Chevron* federal courts began to interpreted the "incidental powers" clause in ways favorable to banks and against the insurance industry.

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[281] 12 USC § 92 as added Sept. 7, 1916, Ch. 461, 39 Stat. 753.

[282] Comptroller issued 12 C.F.R. § 7.7100 in 1971 to clarify a 1916 modification to the Federal Reserve Act, 12 USC § 92, which allowed national banks to sell insurance in towns of less than 5000. The dispute in the 1990s was over whether or not the national bank had to be headquartered in the town or if a branch in the town was sufficient.

For example, in 1987 the insurance industry challenged the Board's decision to eliminate its 1979 requirement that a bank holding company must have its principle place of business in a small town to conduct insurance business there. In *Independent Insurance Agents of America v. Board* (1987), the DC Court of Appeals concurred that the Board's decision was within its discretion given the modifications of the BHCA by the Garn-St. Germain Act of 1982.[283]

Also, in 1987, the Board approved the applications of two bank holding companies, Sovran Financial Corporation (Sovran) and Maryland National Corporation (MNC), to retain insurance agency operations of recently acquired bank holding companies. Again, the insurance industry sued and lost.[284] In 1988, the DC Court of Appeals ruled in *American Ins. Ass'n v. Clarke* (the so-called "AMBAC" case) that the

[283] *Independent Ins. Agents of Am. v. Bd. of Governors*, 835 F. 2d 1452 - Court of Appeals, Dist. of Columbia Circuit 1987. The original "principal place of business" requirement itself evolved from common law. One intent of the BHCA was to separate banking from commerce. The Federal Reserve Board had responsibility for maintaining that separation. The particular provision at issue was that a bank holding company is prohibited from owning shares in companies engaged in nonbanking activities unless the Board determines that such activities are "so closely related to banking ... as to be a proper incident thereto." Beginning in 1971, the Board determined that certain types of insurance agency and underwriting activities were "so closely related" to banking that bank holding companies could engage in them. One of these was the sale of any insurance in a community that had a population not exceeding 5,000. In 1979, in response to a decision of the United States Court of Appeals for the Fifth Circuit instructing the Board to support this small town exemption with "further findings which establish the necessary close relationship of banking to general insurance agency activity in towns with populations not exceeding 5,000," *Alabama Association of Insurance Agents v. Board of Governors,* 558 F.2d 729, 731 (5th Cir.1977), *cert. denied,* 435 U.S. 904, 98 S.Ct. 1448, 55 L.Ed.2d 494 (1978), the Board imposed the "principal place of business" requirement, which limited the small town exemption to bank holding companies that had their principal place of business in a small town.

[284] *Nat. Ass'n of Cas. & Sur. Agents V. Bd. of Gov*., 856 F. 2d 282 - Court of Appeals, Dist. of Columbia Circuit 1988

respective federal regulatory agencies for banking have the authority to authorize a bank or bank holding company to offer municipal bond insurance.[285]

The real turning point for the insurance industry came in the 1990s. In a landmark case, *Barnett Bank v. Nelson* (1996) the Supreme Court reinforced that the McCarran-Ferguson Act of 1945 granted primacy in insurance regulation to the states. However, the Court carved out a crucial exception.[286] Recall that the Comptroller issued 12 C.F.R. §7.7100 in 1971 to clarify a 1916 modification to the National Banking Act, 12 USC 92, in order to allow national banks to sell insurance in towns of less than 5000. In 1992, approximately 179 national banks in fifteen states were taking advantage of this law to sell insurance. The dispute with Florida was over the issue of whether or not the national bank had to be headquartered in the small town, or if a branch of the bank was covered by the federal law. The state of Florida claimed its insurance law prevailed over the federal law. Hence Florida would have prevented a branch of Barnett Bank from selling insurance in a small town. The Supreme Court held instead that the federal law prevailed because it "specifically relates to the business of insurance," thus passing the McCarran-Ferguson test."[287]

The *Barnett* (1996) case was particularly troubling for the insurance industry, because the of the Supreme Court's assurance that judicial "deference would be accorded

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[285] *American Ins. Ass'n v. Clarke*, 865 F. 2d 278 - Court of Appeals, Dist. of Columbia Circuit 1988.

[286] The McCarran-Ferguson Act, 15 U. S. C. § 1012(b) provides that a federal statute will not preempt a state statute enacted "for the purpose of regulating the business of insurance" unless the federal statute "specifically relates to the business of insurance."

[287] *Barnett Bank of Marion Cty., NA v. Nelson*, 517 US 25 - Supreme Court 1996. See appendix 2 for a description of the decision. See also *United States Nat. Bank of Ore. v. Independent Ins. Agents of America, Inc.*, 508 US 439 - Supreme Court 1993; *Owensboro Nat. Bank v. Moore*, 803 F. Supp. 24 - Dist. Court, ED Kentucky 1992, p. 31 for the early 1990s judicial history leading to the *Barnett* decision.

to future OCC decisions concerning expanded banking powers." To insurers, this decision was a wake-up call that it needed to participate meaningfully to scope financial services modernization legislation. That is, after *Barnett*, the insurance industry realized that it was at risk of losing its long-held exemption from federal oversight and began to look earnestly for ways to stem the regulatory and judicial rollback of the New Deal financial regulatory structure. This case was at the heart of the specific compromise laid out by the insurance industry to accept repeal of Glass-Steagall; to wit, that it would preserve state regulation of insurance, also known as the "functional regulation" compromise.[288]

In the end, the judicial decisions from the 1980s and 1990s led to two inescapable conclusions. First, excepting only that the banking regulators had to be interpreting the primary legislation that affected them (e.g., the Bank Holding Company Act for the Federal Reserve, or National Banking Act for the OCC), the federal courts would defer to their interpretations to undermine Glass-Steagall. The Board and Comptroller both used this judicial deference to allow bankers to encroach significantly into securities activities previously reserved for investment banks. Second, especially as regards insurance, the Supreme Court had adopted a new standard that removed the assurance that state law would prevail in matters of insurance regulation. And, based on OCC interpretations, this new interpretation was going to allow bankers to move further into insurance sales.

Pushing Back: Securities and Insurance Firms in Banking

Almost from the onset of Glass-Steagall, commercial banks deliberately pushed on the boundaries of the New Deal banking regulatory structure. Similarly, both broker-

[288] Mark Olson, "H.R. 10: Same Song, New Verse," *Ernst & Young Insurance Executive,* Spring 1999.

dealers and insurance companies had occasionally found loopholes to enter banking. However, in the 1980s, federal regulators began as a matter of policy to enable banks to undertake both securities and insurance activities. At the same time, the courts were deferring to the expertise of federal regulators in the absence of Congressional direction.[289] Not surprisingly, while commercial banks began to take advantage of the opportunity to offer other financial services, the investment banks and insurance companies also sought ways to fight back by pushing into businesses formerly restricted to commercial banks by Glass-Steagall.

During various legislative efforts to repeal Glass-Steagall beginning in 1988 the securities and insurance industries had been willing to undertake reform of Glass-Steagall as long as their interests were considered. However, bankers continued pushing into traditional securities and insurance businesses on the regulatory and judicial front due to their declining profitability and eroding competitive position. This left doubt in the minds of broker-dealers and insurance industry leaders that the commercial bankers were operating in good faith, especially since bankers already had already been successful in removing other New Deal banking restrictions on interest rates, branching, and interstate banking.

The success of the commercial banking industry and its regulators in court became a significant factor in overcoming the reservations held by the securities and

[289] Other cases not addressed in the text include: *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys*., 468 U.S. 137 (1984), which challenged approval by the Federal Reserve for Banker's Trust to sell commercial paper; *Sec. Indus. Ass'n v. Bd. of Governors of the Fed. Reserve Sys*., 900 F.2d 360 (D.C. Cir. 1990), which challenged a Federal Reserve Board order permitting J.P. Morgan & Co., Inc., the Chase Manhattan Corporation, Banker's Trust New York Corporation, Citicorp, and Security Pacific Corporation to use a nonbank subsidiary to sell debt and equity securities.

insurance industries towards comprehensive financial services modernization in the form of GLBA. That is to say, the leadership of the securities and insurance industries realized they were losing the battle in court and needed to adopt new tactics. In order to bring the banks to a fair legislative compromise, the other financial services industries realized they needed a counterweight to the bankers' regulatory and judicial successes.

Relative to the pressure commercial banks had been placing on the securities and insurance industries, the most significant counter came from the large insurance companies, which had the resources to compete directly with the commercial banks. The first attempt by insurance and securities firms to end-run Glass-Steagall had been to employ the nonbank bank legal construct to gain the resources of banking deposits while intentionally avoiding bank regulations. As discussed earlier, Congress foreclosed this option after a strong lobbying campaign by banks when it passed the Competitive Equality Banking Act (CEBA) in 1987. After that the insurance companies continued to explore other ways to circumvent Glass-Steagall in order to both push back on banks and ensure their own competitiveness. In the 1990s, insurers discovered such a loophole in the unitary thrift holding company (UTHC).[290]

As background, the Savings and Loan Holding Company Act of 1967 (SLHCA) contained a relatively unused exception that, "(A company) owning only a single thrift institution was not subject to any restrictions on other activities undertaken by the company so long as the thrift subsidiary was a qualified thrift lender (QTL)."[291] This

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[290] Steve Cocheo, "What's at Stake with Unitary Thrifts," *ABA Banking Journal* 89, No.10, October 1997: 76.

[291] 12 U.S.C. section 1730a (1994). A QTL was defined as a thrift with at least 65% of its assets in mortgage or consumer related lending. Of note, the percentage was calculated on the assets of the thrift, not the parent company.

exception had been used by retail firms such as Ford and Sears to enter banking in the 1980s, but there was no inherent restriction on insurance companies also making use of the exception to establish UTHCs. In other words, an insurer could acquire a single thrift and, if it met the QTL test, that thrift would not be subject to other restrictions on the insurance company, including those imposed by Glass-Steagall or the BHCA.[292]

This was significant because it allowed an insurance or retail company to own a single QTL and still be able to conduct its nonbanking business. Indeed, since Glass-Steagall did not apply to thrifts, the UTHC had several important advantages over the traditional bank holding company. These included: 1) Unlimited ability to merge banking and commerce; 2) Unlimited ability to affiliate with any type of financial institution – insurance, bank, securities; 3) Unlimited interstate and intrastate branching; 4) minimum Office of Thrift Supervision (OTS) regulation at the holding company level, including no holding company capital requirements; and 5) for federal savings association subsidiaries, preemption of state deposit and lending laws.[293]

The campaign to establish UTHCs as a way for insurance companies to enter banking was successful in applying pressure to the commercial banking industry. Since there were no barriers to creating more UTHCs, in the late 1990s insurance companies began to leverage them to fight back against the regulatory and legal victories that were allowing banks to encroach on insurance business. [294] In 1997, the ABA found that at least 73 unitary thrift holding companies (UTHC) engaged in financial activities that were barred to bank holding companies because of exclusions in Glass-Steagall or the

[292] John Krainer, "The Separation of Banking and Commerce," *Economic Review*, January 2000, 15.
[293] Cocheo, "What's at Stake with Unitary Thrifts," 76.
[294] Broome and Markham, "Before and After," 723-64.

Bank Holding Company Act. More to the point, perhaps, several major insurance companies followed this path to offset the inroads large commercial banks were making into the insurance business. Examples included the Principal Financial Group, Travelers, State Farm, American International Group, Inc., and The Equitable Companies.[295]

Ultimately, if the carrot for the banking industry to come to the table for legislative repeal of Glass-Steagall was codification of gains and efficiency of operations, then the stick was the ability of the securities and insurance industries to take advantage of the unitary thrift loophole to enter banking. The establishment of UTHCs by large insurance companies in particular represented genuine competition to the large commercial banks, and the banks wanted to stop it.

Chapter 2 Conclusion: Assessing the Regulatory Path

This chapter lays out the sequential path to repeal of the Depression-era U.S. banking regulatory framework. It reflects the fragmented nature of the U.S. policy process. Although Congress was driven by crisis to legislatively repeal Regulation Q interest rate limitations and interstate branching restrictions, it was unable to reach agreement on repealing Glass-Steagall itself during the late 1980s because of disagreements among the financial services industries and their regulatory communities. As a result, throughout the 1990s the commercial bankers and their trade associations sought to change the bank supervisory agencies' interpretations of Glass-Steagall and

[295] Steve Cocheo "What's at Stake with Unitary Thrifts," 74. At the end of 1996 there were 704 UTHC according to the OTS. In a Spring 1997 background paper OTS pointed out the range of activities included those concentrating on their thrift, diversified multi-billion dollar parents, and many mid-sized companies that engage in just a few activities.

BHCA restrictions administratively, and contested the resulting regulatory actions in court when opposed by representatives of the securities and insurance industries.

The bankers' focused effort to undermine Glass Steagall through regulatory action over the course of the 1980s and 1990s came at the end of a determined long-term campaign by the ABA and large commercial banks. It played out against a backdrop of technology-driven innovation blurring the line among financial products and services, international competition from the globalization of financial markets and trade, and competition among the financial services industries themselves as the New Deal regulatory paradigm eroded in the face of economic conditions such as rising interest rates.

Briefly, the large commercial bankers historically opposed Glass-Steagall even before the law was even passed. They continued to make inroads over time against Regulation Q, interstate and branch banking restrictions, as well as the separation of banking from securities and insurance by leveraging work-arounds such as bank holding companies. Despite a history of opposition to allowing large commercial banks into their markets, even smaller banks began to seek reform despite having some exemptions to Glass-Steagall if they were not Federal Reserve member banks. The issue for the community banks was that the threat from interest rate and geographic restrictions, disintermediation, and technology driven changes outweighed the local competitive threat from large commercial banks. At the same time, over the course of the 20th century the security broker-dealers and insurance industries sought to sustain their mote from competition with the bankers, but also leveraged loopholes such as the nonbank bank to encroach on the business of banking.

Congress lacked a consensus on repealing the venerable Glass-Steagall Act even after a series of crises forced it to take legislative steps to lift interest rate and geographic restrictions. Pending congressional action on repealing Glass-Steagall itself, the federal banking regulators began to accede to bankers' demands for relief. The federal banking regulators' new approach was notable in that it reflected a changing ideological consensus about the role of regulation in the markets from Keynesianism to neoliberalism. The U.S. commercial banks were seeking to improve their competitiveness against both foreign banks and the other financial services industries in the face of dynamic market conditions. However, the issue here was not so much the bankers' natural self-interest as it was the federal bank regulators' genuine concern for the competitiveness of U.S. banking sector, which led them to support undermining Glass-Steagall while also reinforcing the need for Congressional action.

At the same time federal courts, following the precedent of deferring to regulatory experts in the absence of clear Congressional guidance, began to approve federal regulatory decisions to expand the role of commercial banking in the economy beyond that envisioned by Glass-Steagall. In response, especially after a series of losses in federal court, the security broker-dealers and insurance firms continued their fight with the bankers in the market by adopting the unitary thrift holding company (UTHC) structure to compete with the large commercial banks. As a result, it became clear that no legislative repeal of Glass-Steagall could occur until the major factions among the financial services industries were able to compromise among themselves.

On a related note, the banking regulators' focus on restoring the competitiveness of the U.S. banking industry created tension among themselves and with state banking supervisors, in that the Comptroller, Federal Reserve Chairman, and FDIC Chairman did not always agree on the right approach. The banking regulators agreed even less often with the SEC and state insurance commissioners, which resulted for a time in the regulators seeking to protect their own authority under the variously proposed regulatory schemes. And, as the banking regulatory agencies became important in the eyes of Congress for their expertise, it became equally apparent that the regulatory agencies themselves would have to reach accommodation over their differing jurisdictions.

The fact that Congress was unable to complete comprehensive reform of the Depression-era banking regulatory system had two important implications. First, in addition to DIDMCA and Riegle-Neal undercutting New Deal banking restrictions through legislation, the bankers succeeded in rendering Glass-Steagall largely ineffective by regulatory and judicial decisions before the passage of GLBA. This regulatory campaign laid the ground work for the legislative repeal of Glass-Steagall by GLBA, but it also meant that the actual deregulatory impact of GLBA was less transformational than generally understood since many of the barriers separating banking, securities and insurance had already been breached.

Second, the successive nature of efforts to repeal Glass-Steagall along with other aspects of the New Deal banking structure also helps explain why financial services modernization, when it finally came, ended up limited to the repeal of Glass Steagall rather than including safety and soundness provisions for new financial markets and products. That is, the piecemeal and delayed approach to banking deregulation necessarily kept the attention of the financial services industry, their regulators, and Congress focused for decades on updating the Depression-era framework rather than comprehensively modernizing for new market conditions. Then, as bankers, securities broker-dealers, and insurance agents maneuvered for advantage over Glass-Steagall with Congress, key regulators, and the courts, the entire community appeared to miss that emerging technologies and market innovations were creating new products and services that required comprehensive legislation to modernize financial regulations. Finally, as the financial community became accustomed to working deregulation piecemeal, there was correspondingly less pressure to deal with derivatives and other new securitized financial products and markets as part of comprehensive financial services modernization.

In the end, it was clear that legislative repeal of Glass-Steagall would require accommodation among the various financial services industries and their regulators. In the meanwhile, the campaign to undermine Glass-Steagall continued through private actions, administrative decisions, and the courts. By 1998, the Glass-Steagall framework already had lost much of its effectiveness through regulatory rulemaking and judicial deference without any change to statutory language or congressional intent. What was lacking was any comprehensive approach to financial regulation that would both enhance the competitiveness of the U.S. financial sector and provide adequate safety and soundness regulations for U.S. financial institutions and markets. It was left to Congress to decide how long that situation would continue. Those legislative efforts and their impediments are introduced in the next chapter.

Chapter 3: The Opening Act for Gramm Leach Bliley

Congress returned to the repeal of Glass-Steagall in 1997 after nearly a decade of incremental efforts in the regulatory and judicial arenas subsequent to the failure of Senator Proxmire's bill in 1988.[296] This chapter outlines the major political issues and events of the 105th Congress that shaped financial modernization legislation in the late 1990s. The lesson that emerged clearly for financial industry leaders and policymakers alike was that comprehensive financial services modernization was politically untenable. This led them to focus on a narrow law to lift the restrictions on the affiliation of commercial banking, securities, and insurance. As a direct consequence, the proposed reforms retained much of the underlying regulatory infrastructure and omitted safety and soundness measures to address financial innovations. Even though Congress ultimately was unable to repeal Glass-Steagall in the 1997-1998 sessions, the structural impediments identified and policy issues discussed during this period set the stage for the 1999 Gramm Leach Bliley Act (GLBA) to repeal Glass-Steagall.

A number of factors converged in 1997 to convince Congress that the time had come to once again consider a legislative repeal of Glass-Steagall. Congress had already disposed of several major Depression-era features of the U.S. banking system, including interest rate and geographic restrictions, to establish a pattern of sequential reform. Further, the large commercial bankers' long term regulatory and judicial campaign had undercut Glass-Steagall while at the same time consolidation within the financial services markets threatened in effect to nullify the law. These considerations combined to focus

[296] The Financial Modernization Act of 1988 (S.1886) was proposed by Senator William Proxmire, D-WI, and ranking minority member Senator Jake Garn, R-UT. As discussed in Chapter 2, their bill passed the Senate but not the House.

Congress on financial services modernization, if only to ensure the final market structure and oversight was driven by legislation and not by regulatory and judicial decisions.

Yet once the legislative debate opened, the divergence of interests and diffusion of power among major stakeholders and policy-makers ultimately caused Congress to narrow the scope of financial modernization to focus just on the repeal of Glass-Steagall itself in order to achieve consensus. Although politically expedient, this approach foreclosed the possibility of broader reform for the financial sector, including safety and soundness improvements necessary for innovative and new products and institutions.

The shift of financial services modernization efforts to the legislative arena in the 105th Congress occurred in the context of on-going regulatory and judicial actions during the 1997-1998 timeframe. During this period, the Supreme Court ruled on several key cases involving insurance, banking, and credit unions. Major banks also continued to force unprecedented mergers. For example, the Federal Reserve's approval of the Citicorp-Travelers merger provided an important forcing function in the Congressional debate. The practical effect of the Fed's actions in approving the formation of Citigroup, and the courts' acceptance of it, was to render the Glass-Steagall paradigm effectively moot. The resulting congressional debate over judicial, regulatory, and market actions reached an inflection point as it brought the policy community to accept that legislative action was necessary for additional progress to be made in financial services modernization.

Congressional leaders and Administration officials took advantage of the move to the legislative arena to broaden the debate beyond the repeal of Glass-Steagall advocated by the large commercial bankers and federal banks supervisors to incorporate the concerns of community bankers, state regulators, consumer activists, and both securities and insurance industry leaders. While the President literally brought veto points to bear in the legislative wrangling, Congressional committee chairs figuratively did so as well. As a result, the President's supporters were able to introduce several new issues into the Congressional debate, including financial privacy regulations and an extension of the Community Reinvestment Act. Similarly, the congressional committee chairmen played a critical role in leveling the political playing field for community bankers and state insurance associations as they sought to counter the massive lobbying power of large financial institutions. For example, the advocacy of House Banking Committee Chairman James Leach, R-IA, elevated the influence of community bankers, whereas House Commerce Committee Chairman Thomas Bliley, R-VA, was able to extract concessions on behalf of state insurance associations.

At the same time, the government regulators themselves fought to determine which agencies would control financial services oversight under the new regulatory regime. For example, among banking regulators a dispute developed between Greenspan on the one hand and Rubin, Ludwig, and Helfer on the other over the appropriate organizational structure for bank holding companies. This argument was important because it would determine the balance of power between the Federal Reserve's authority to regulate holding companies and the OCC and FDIC authorities to regulate banks.

The divisions between leading bank regulators, SEC Chairman Levitt, and state insurance commissioners were also significant. These disputes centered on the nature of supervision of securities and insurance activities at banks. The crux of the matter was a dispute over institutional versus functional regulation. Bank supervisors advocated the retention of institutional regulation in which they maintained oversight of all financial activities that took place in banks. The securities and insurance regulators instead preferred functional regulation, in which they had oversight of securities and insurance activities when conducted in banks. For example, Commissioner Levitt argued the SEC should have oversight of securities trading by banks. The insurance trade associations seemingly broke this impasse during the 105th Congress with an offer to accept financial modernization if insurance sales in the national banks were made subject to state insurance rules. Although the actual implementation of the so-called functional regulation compromise resulted in a mixed final regulatory structure that changed much less in practice than implied in the rhetoric of the legislation.

As for the financial services industries, the threat that each group posed to the others' business model gave all sides a reason to come to the political negotiating table. The fact that that the major industry players were finally willing to consider compromise on repeal was a major factor in re-opening serious negotiations in Congress. Specifically, the success of the commercial banks in undermining the New Deal banking regulatory structure in court was offset by the insurance industry's success in adopting the unitary thrift holding company as a way to enter banking. Although trade associations and lobbyists framed the issue in terms of consumer benefit, their on-going actions made clear that the financial services industry members primarily sought repeal of the Glass-Steagall framework for their own benefit rather than to improve the financial system per se. That is, bankers sought to consolidate their regulatory and judicial gains while insurers and securities dealers sought to level the regulatory burden among the financial services industries.

The 105th Congress became an important clearinghouse for roadblocks to repeal of Glass-Steagall. In particular the issues identified and compromises offered during the 1997-1998 Congressional debates were necessary in order for Gramm Leach Bliley to pass in 1999. The key take-away from the debates was that compromise was necessary in order to make progress. As a result, Congress and the Administration were able to inject reforms into the debate that were intended to support consumers, small bankers, and state and local communities. Yet overall the scope of reform continued to move from comprehensive financial modernization towards a relatively narrow focus on removing the Glass-Steagall restrictions on commercial banks, broker-dealers, and insurance underwriters. Unfortunately, this narrower view also limited the possibilities for financial modernization to include necessary improvements in safety and soundness regulation to accommodate changes and innovations in the financial markets since the Depression-era financial structure was established.

A Legislative Policy Window Opens

This section discusses the players and factors that shaped the political debate in Congress. Unlike in previous instances of major legislative banking reform, which were driven by financial crises, the return of the Glass-Steagall debate to Congress in 1997 was more a matter of deliberate reflection on national banking.[297] Opening the legislative debate provided an opportunity for the major factions, including the financial services industry, their lobbyists and trade associations, federal regulators, the Clinton Administration, and Congressional leaders to establish their positions on banking reform.

[297]Steve Cocheo, "Leach Offers Hints on Game Plan for New Congress: Calls OCC Gambit a Potential Monkey-wrench," *ABA Banking Journal* 89, No.1 (January 1997): 7.

New Congressional Leadership

House Banking Chairman James A. Leach, R-IA, brought strong Congressional leadership to the issue of financial modernization legislation. Jim Leach became Chairman of the House Banking Committee with the Republic take-over of the House in 1994, and was now in his nineteenth year in the House. Representing a rural community, he was known for his views that banks had a unique role in the American economy. In particular, he argued that community banks served as the engine for small business and agriculture because they funneled bank deposits into these local enterprises. Over the years, he became an expert on bank finance. And, unlike his predecessor as chairman, Congressman Henry Gonzalez, D-TX, Leach was known to be a strong backer of the Federal Reserve Chairman Alan Greenspan's view on financial services modernization.

In particular, Leach embraced Greenspan's view that foreign banks and other domestic financial industries providing banking services threatened the U.S. banking system. He saw banking reform as necessary for the U.S. to regain its competitive edge in world finance. Asked directly by *ABA Banking Journal* executive editor Steve Cocheo about the need for H.R. 10, the House version of the Financial Services Modernization Act, Leach replied:

> Unless something is done, the banking system is in great danger. So, we're trying to open up competition. That is good for the customer. Banks are the institutions that serve local needs the most. There will be more competition, to bring more choices to the consumer and so they can do more one-stop shopping. And H.R. 10 will bring more investment banking products to smaller institutions. [298]

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[298] James A. Leach, quoted in Steve Cocheo, "One More Time," *ABA Banking Journal* 89, No.3 (March 1997):34.

In other words, Leach accepted the neoliberal notion that more competition in the market would lead to better economic results both for the financial industry and for the consumer. As a result, he became an indefatigable champion for financial modernization.

Of course, the strength of Leach's leadership did not mean he was unopposed in his views. In the first place, House Commerce Committee Chairman Thomas Bliley, R-VA, had co-jurisdiction over financial services legislation as it affected insurance and securities. To the extent that Leach focused on banking, there was a natural tension with Bliley's focus on the interests of the insurance and securities industries. Second, Senate Banking Committee Chairman Alphonse D'Amato, R-NY, had an equally strong platform. However, he was reluctant to engage in major legislation due to his reelection campaign in 1998, for which he needed the support of both the large commercial bankers and major New York based insurance companies. That is, D'Amato could not afford to alienate either the large bankers or insurance firms and preferred to delay action on banking reform. Finally, Leach and his Republican colleagues had to contend with experienced congressional Democrats such as John Dingell, D-MI, who supported the views of consumer advocates and other groups that opposed repeal of Glass-Steagall.

Strong Impetus by the Federal Banking Supervisors

Federal banking regulators, especially the Federal Reserve, OCC, and FDIC, remained committed to undermining Glass-Steagall in order to increase the global competitiveness of the U.S. financial industry.[299] Federal Reserve Governor Laurence

[299] Philip A. Wallach, "Competing Institutional Perspectives in the Life of Glass–Steagall," *Studies in American Political Development* 28, no. 01 (April 2014): 26–48 noted that except in cases that affected federal deposit insurance, the FDIC followed the lead of the Federal Reserve and OCC. For example, the FDIC supported security affiliates for non-member banks that came under its regulatory oversight.

Meyer, who chaired the Board's Committee on Supervisory and Regulatory Affairs, reflected the changed ideological consensus when he observed that, "The prohibitions against banking and securities and banking and insurance combinations have always, it seems to me, been difficult to support."[300] Virgil Mattingly, Chief Counsel of the Board of Governors of the Federal Reserve, reinforced Meyer's view. He claimed, "There was a general consensus that any legislation should authorize banking organizations to affiliate with a broad spectrum of entities engaged in financial activities, including securities brokers and dealers, investment advisors, and companies engaged in underwriting and selling insurance products."[301]

The banking regulatory community's encroachment on Congressional prerogatives risked a backlash from Congress. For example, Leach took exception to the aggressive stance taken by Comptroller Ludwig's liberalization of the OCC's Part 5 rules in 1996 because it undermined Leach's own efforts to achieve a consensus among major players in the financial services community. Or, as Leach put it, "Now the landscape has been peremptorily tilted by the Comptroller with his Part 5 operating subsidiary rules, (which) could cause some parties not to come to the table." However, Leach's irritation aside, there is little doubt that it was the regulatory response to the plight of U.S. banking in the face of Congressional inaction that finally induced Congress to take up Glass-Steagall repeal again after a decade.[302]

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[300] Laurence H. Meyer, "Issues in Financial Modernization," Remarks presented at the Conference on Financial Structure, The Jerome Levy Economics Institute of Bard College, Annandale-on-Hudson, New York (April 10, 1997): 1-8.

[301] J. Virgil Mattingly and Keiran J. Fallon, "Understanding the Issues Raised by Financial Modernization," *North Carolina Banking Institute* 2, no. 1 (1998): 25.

[302] Cocheo, "Calls OCC Gambit a Potential Monkey-wrench," 7.

Market Activities

Consolidation within and among the financial services industries also threatened to render the Depression-era regulatory structure moot. As regulators continued to allow mergers and activities that previously would have been considered in violation of Glass-Steagall, Congressional leaders such as Leach realized that legislation was necessary in order reassert Congressional prerogatives.

In addition to the banking mergers described in Chapter 2, the pace of merger and acquisition (M&A) activity drove competition within the investment banking industry. In particular, the profits available in M&A in the late 1990s encouraged the brokerage arms of commercial banks to enter what had been traditionally an investment banking specialty. In one example, NationsBank, the fourth-largest U.S. commercial bank, bought Montgomery Securities, a top ten stock underwriter.[303] Investment bankers also faced competition from their former customers, as mergers and acquisition activity at some companies prompted them to develop in-house expertise. For example, Conseco, which had completed 15 acquisitions involving 30 mergers insurance companies since the 1980s, completed its last four deals without an external investment adviser.[304]

The insurance industry was consolidating as well. This was partially driven by economies of scale from more efficient information technologies, and partially by the pressures of competition from insurance sales in banking. According to Robert Hogue of the *Insurance Advocate,* "I can't recall a period that compares with this merger boom." He reported that in 1997 alone there were 46 life and health insurance company mergers,

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[303] This was allowed as the "Section 20" exceptions as long as the revenues from investment banking activity were less than 25% of the investment bank total.

[304] "Competition Intense between Mergers and Acquisitions," *Insurance Advocate* 109, no. 11 (March 14, 1998): 26.

and 73 property and casualty mergers. And at the point Hogue was reporting, the pace continued with 17 deals announced for 1998.[305]

Furthermore, given the recent regulatory and judicial approvals to allow some banking activities in insurance and securities, there were on-going efforts among the bankers and insurance agents to make these new overlapping businesses arrangements work. For example, a 1998 survey by America's Community Bankers (ACB) noted that 43% of community banks offered life insurance.[306] There was initially quite a bit of confrontation between the trade associations of the two industries as the number of banks involved in insurance grew through the 1990s. However, as bank insurance officers and insurance agents began to perceive that selling insurance through or in partnership with banks could increase profits, they became more supportive.[307]

While many agents continued to oppose any incursion by banks into insurance sales, a joint survey in 1997 by the American Bankers' Association (ABA) and Independent Insurance Agents of America (IIAA) documented an important shift, indicating a rapprochement among the industries at the working level. This rapprochement was an important factor driving renewed interest in the repeal of Glass-Steagall. In other words, the longer Congress delayed action, the less relevant the new

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[305] Robert D. Hogue, "The Merger Boom," *Insurance Advocate* 109, no. 10 (March 7, 1998): 32.

[306] Steven Davidson, "Insurance Strategies for Banks" *America's Community Banker* 7, no. 7 (July 1998): 38.

[307] Joe Asher, "Yesterday's foes, tomorrow's allies?" *ABA Banking Journal* 90, No. 1 (January 1998): 33-38.

legislation would be except perhaps as acknowledgement of the new market and regulatory status quo. [308]

The View from the Financial Services Industries

In general, the major trade associations representing the banking, securities, and insurance industries now agreed that the Glass-Steagall regulatory framework required overhaul in order to encourage the strength and growth of the American financial sector, as well as to reflect the modern financial landscape. As former Representative Larry LaRocco, D-ID (1991-1995), managing director of the American Bankers Association Securities Association, commented, "Glass-Steagall is dead. It's dead…it's unfortunate that the marketplace is moving so far ahead of the Congress."[309]

Reflecting market realities, both large and small bankers decided to work together to influence Congressional action where they could find common ground. Given their successes in the administrative and judicial spheres, the ABA and large bankers in general came to the legislative table from a position of strength relative to the securities and insurance trade associations. For their part, the large commercial bankers already had been successful with regulators and the courts in slowly expanding into securities and banking well beyond the separation originally envisioned in the Glass-Steagall framework. In addition, the position of the banking community as a whole was fortified by an emerging partnership between large and small bankers. This new relationship

[308] Asher, "Yesterday's foes, tomorrow's allies," 33-38 reported the results of a survey, "Selling Insurance through Banks-Agent and Banker Perspectives and Strategies." Asked how the IIAA could best represent them on the issue of banks-in-insurance, 23% asked for opposition, but 54% asked to level the playing field, and 21% asked for assistance in establishing joint ventures (as opposed to acquisition by banks).

[309] Lori Nitschke, "Banking: House Panels Inch Toward Deal on Financial Services Overhaul," *CQ Weekly* (March 7, 1998): 539–40.

among bankers was best exemplified in an evolving partnership between the ABA and ACB trade associations in support of financial modernization. As ACB President Paul Schosberg said:

> Our approach to financial modernization has sought the broadest, most flexible range of options so bankers might better cope with the changing nature of competition, shifting needs and perceptions of consumers and swings in economic conditions. With all that at stake, turf wars and trade association politics-as-usual are luxuries no banking sector can afford.[310]

Even so, it would be a mistake to view the large and small commercial bankers as singular in their objectives for financial modernization. Small bankers had specific goals that went beyond those of the large commercial bankers, such as fair competition, stable capital structures and access to funding, and preserving the option for a thrift charter. Although the ABA and ACB were able to come to common ground on repeal of Glass-Steagall, they specifically parted ways on two issues: the federal thrift charter and unitary thrift holding companies.[311] Furthermore, during this period the leaders of the nation's federal home loan banks formed the Council of Federal Home Loan Banks (CFHLB) as a trade association specifically to advocate for FHLB issues during the financial modernization debates.[312] Indeed, Chairman Leach was persuaded to support the use of

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310 Paul A. Schosberg, "On the Eve of a Convention: America's Community Bankers--a Progressive Voice," *America's Community Banker* 7, no. 10 (October 1998): 7.

311 Mary Dixon, "Banking Is Her Business," *America's Community Banker* 7, no. 12 (December 1998): 14; Tom Coyle and Mary Dixon, "ACB to Implement Strategic Plan," *America's Community Banker* 8, no. 10 (October 1999): 10.

312 Michelle Clayton, "Federal Home Loan Bank happenings," *America's Community Banker* 7, no. 2 (February 1998): 8. Nine banks in the 12-member Federal Home Loan Bank System participate in the council (Atlanta, Boston, Cincinnati, Des Moines, Indianapolis, Pittsburgh, San Francisco, Seattle and Topeka), which was intended to provide a forum for the FHLBs to consider public policy matters and communicate Federal Home Loan Bank issues and accomplishments.

the FHLB system to stabilize community banks during a 1997 meeting with small bankers led by Jeff Plagge, president and CEO of First National Bank, Waverly, Iowa.[313]

From the perspective of the securities industry, legislation to repeal Glass-Steagall was necessary to restore balance between investment and commercial banking. A decade of regulatory and judicial decisions had left commercial banks with the ability to either acquire or affiliate with investment banks and broker-dealers. However, these regulatory decisions were in support of exceptions to the law made by banking regulators. Glass-Steagall continued to prohibit securities firms from acquiring banks. In addition, the Securities Exchange Commission (SEC) had concerns about the ability of banking regulators to provide effective oversight of the securities underwriting now permitted to banks. The SEC commissioners sought to rationalize the regulation of securities products under SEC auspices wherever they were underwritten or sold, including in commercial banks.[314]

The question of what repeal would mean to banking and insurance was even more contentious. The banking industry's perspective was that it had won what was necessary in two recent Supreme Court decisions that permitted banks to conduct insurance activities despite state statutes to the contrary, and allow the OCC to define insurance for the purposes of national banks.[315] Bankers were determined that any financial modernization law not undermine those regulatory and judicially granted authorities. On

[313] Joseph Pigg, "An end to funding volatility?" *ABA Banking Journal* 91, No. 12 (December 1999): 16-17.

[314] Securities and Exchange Commission, "Concerning Bank Securities Issues," Statement to the Subcommittee on Oversight And Investigations Committee on Commerce U.S. House Of Representatives, Washington, D.C., June 25, 1999.

[315] *Barnett Bank v. Nelson*, 517 U.S. 25 (1996), and *NationsBank v. Variable Annuity Life Insurance Company*, 513 U.S. 251 (1995).

the other hand, the insurance industry approached the issue from the perspective of the McCarran-Ferguson Act, which reserved to states the right to both define and regulate insurance.[316] Both the insurance industry and state insurance commissioners argued that it would provide large commercial banks an unfair advantage if they could sell insurance without complying with state regulations. This dispute remained at the heart of the dispute between bankers and insurers throughout the legislative debate.

In order to pressure banks, the American Insurance Association (AIA) continued to encourage its members to acquire unitary thrift holding company (UTHC) charters. Not only did UTHCs offer an unrestricted ability to affiliate among depository institutions, insurance and securities companies, they also had no restrictions on interstate or intrastate banking, and came with relatively light regulation from the Office of Thrift Supervision (OTS) at the holding company level. For example, OTS imposed no capital requirements at the thrift holding company level. In contrast, the Federal Reserve imposed capital restrictions on commercial bank holding companies. These advantages were obvious to the banking community and bankers found the unitary thrift loophole to be a credible threat to their business model.[317]

As a result, the ABA's position on financial modernization was that, "Any… bill that maintains the status quo with respect to the thrift charter and unitary thrift holding companies would be seen by many bankers as a breach of faith by Congress." Indeed, it was over this issue that the ABA under President Bill McConnell killed H.R. 10 in the

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[316] See footnote 283.

[317] Steve Cocheo, "What's at Stake with Unitary Thrifts," *ABA Banking Journal* 89, No.10, October 1997: 74. While perhaps biased to the S&L industry, a 1997 OTS study concluded that a diversified UTHC structure also stabilized the underlying thrift by providing liquidity, access to capital, and lowered borrowing costs.

first session of the 105th Congress, and the issue on which it spent the majority of its effort in the Senate in the second session. It became abundantly clear that the ABA had sufficient grassroots and lobbying muscle to prevent a bill from passing unless it closed this loophole.[318]

The bottom line was that by 1997 the financial services industries were ready for legislation if a reasonable accommodation could be reached on their major issues. While banks had been achieving their goals in court, the insurance industry hit on an effective way to bring them to the table with the unitary thrift issue. Until this time the insurance companies, securities firms, and banks had all been at cross-purposes. But now, according to Bill McConnell, "Cross-industry consensus is the only way, ultimately, to get a financial modernization package out of Congress in our lifetimes."[319]

Anti-Competition Concerns

There were also cogent voices in opposition to any repeal of Glass-Steagall despite the emerging general agreement in the policy community that such a repeal would improve innovation, competitiveness, efficiency, and financial services generally. Since the Republican leadership of the banking and commerce committees appeared to be supportive of financial services modernization, those groups against repeal of Glass-Steagall had to find creative ways to register their concerns. Anti-competitive rhetoric served as one surprisingly effective way to oppose repeal of Glass-Steagall.

In an example of Congressional fractiousness, House Judiciary Committee Chairman Henry Hyde, R-IL, held hearings to assess the anti-competitive aspects of

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[318] William T. McConnell, "There's No Turning Back the Calendar," *ABA Banking Journal* 90, No.1 (January 1998):17.

[319] McConnell, "There's No Turning Back the Calendar," 17.

financial services modernization even though his committee was not directly involved in drafting banking legislation. In doing so he was upholding the venerable tradition of congressional committees defending their turf. In this case, Hyde sought to ensure that the banking and commerce committees did not adversely affect the implementation of the Hart Scott Rodino Act (HSR) that governed large mergers in the U.S. economy. The issue here was that commercial banks had an exemption from HSR, and Hyde sought to ensure that the draft H.R. 10 did not allow insurance and securities firms to escape the provisions of HSR by merging with a commercial bank.[320]

Academics argued to the Judiciary Committee that financial industry concentration would have the effect of raising costs and reducing service for small businesses and rural and agrarian communities.[321] Bill McQuillan, President of the Independent Bankers Association, which represented community banks, reinforced this point. He demonstrated that consolidation had actually raised consumer and business user

[320] Henry Hyde, "The Effects of Consolidation on the State of Competition in the Financial Services Industry," Statement of the Chairman presented at the Committee on the Judiciary, U.S. House of Representatives, Washington, D.C. (June 3, 1998): 1-2. Hyde raised the issue of anti-competitive behavior, but the hearings also served as sounding boards for those concerned in general about repealing Glass-Steagall. See also Federal Trade Commission, "Concerning the Effects of Consolidation on the State of Competition in the Financial Services Industry," Testimony presented at the Committee on the Judiciary United States House of Representatives, Washington, D.C. (June 3, 1988): 1-11; Laurence H. Meyer, "Statement of Laurence H. Meyer Member, Board of Governors of the Federal Reserve System," Testimony presented at the Committee on the Judiciary U.S. House of Representatives, Washington, D.C. (June 3, 1998): 1-19; and John M. Nannes, "Statement of John M. Nannes, Deputy Assistant Attorney General Antitrust Division U.S. Department of Justice," Presented at the Committee on the Judiciary, United States House of Representatives, Washington, D.C. (June 3, 1998): 5. All of whom argued the government had adequate protections in place to prevent anti-competitive behavior in the financial services industries.

[321] James W. Brock, "Statement of James W. Brock, Moeckel Professor of Economics Miami University Oxford, Ohio," Testimony presented at the Committee on the Judiciary, U.S. House of Representatives, Washington, D.C. (June 3, 1998): 1-14.

fees as larger banks, including ATM fees, while fees at smaller banks declined over the same period. He was particularly concerned that small borrowers would be crowded out at larger banks. [322] Bill Flory, representing agrarian interests, agreed, "Our fear is that horizontal mergers within the banking sector may not only reduce the availability of credit to farmers and rural America, but will also diminish the level of attention and expertise available to production agriculture."[323] These issues were similar to the ones raised by the CFHLB, ACB, and individual concerned small bankers to House Banking Chairman Jim Leach.[324]

Consumer advocates also expressed a wide range of concerns. For example, Ralph Nader was opposed to the on-going wave of bank mergers regardless of Glass-Steagall repeal. A well-known political activist and consumer advocate, Nader had a reputation for publicizing and encouraging political reform. For example, he and the organizations that he founded were credited with roles in the creation of the Clean Water Act, the Consumer Product Safety Act, and National traffic and Motor Vehicle Safety Act, among others. In this case, he turned his attention to protecting consumers from "too big to fail" financial institutions. He specifically advocated that, "Congress and the

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[322] William L. McQuillan, "Testimony of William L. McQuillan President of the Independent Bankers Association of America," Statement presented at the United States House of Representatives Committee on the Judiciary, Washington, (D.C., June 3, 1998): 1-11. The ATM fee issue took on a life of its own, and was addressed as a stand-alone item in GLBA to require your ATM warn you of the fee charged for withdrawal.

[323] Bill Flory, "Statement of Bill Flory, President of the National Association of Wheat Growers," Testimony presented at the Committee on the Judiciary, U.S. House of Representatives, Washington, D.C. (June 3, 1998): 1-3.

[324] Pigg, "An end to funding volatility?"16-17.

Administration need to evaluate these risks and determine what regulatory and deposit insurance structure is needed to protect the banking system and the taxpayers."[325]

For their part, the ABA and other financial services industries were well aware of consumer related issues. Indeed, the ABA compiled a list that was headed by complaints about unfair pricing. Public accounts abounded with anecdotes about customers of small banks having their costs rise when their bank was bought out by a larger one. This impression was so strong that the Federal Reserve did a study to confirm the phenomenon. It concluded that from 1994-1999 bank fees did indeed rise when local banks were acquired.[326] This came on the heels of a Department of Justice investigation into complaints of price gouging on both ATM and credit card fees. The ABA response was that, "Banks individually and collectively need to do a better job of articulating how the change in the industry will help consumers. As long as consumers and their advocates view these changes as being good for banks and bad for customers, the industry will face escalating regulatory pressure."[327]

Despite any such attempts to frame financial services modernization in terms of benefits to the customer, the Congressional Research Service pointed out that the specific reforms were "largely industry driven. Few customers are actively petitioning Congress to allow one-stop financial shopping." However, this did not mean the claims of the

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[325] Ralph Nader, "Recommendation That Clinton Administration Oppose a Vote on HR 10 in the House of Representatives," Letter to Gene Sperling, Director National Economic Council (April 16, 1998). William J. Clinton Presidential Library & Museum.

[326] Timothy H. Hannan, "Retail Fees of Depository Institutions, 1994–99," *Federal Reserve Bulletin*, January 2001, 11.

[327] Jo Ann S. Barefoot, "Has CRA become anti-bank activists' new all-purpose tool?" *ABA Banking Journal* 90, No. 8 (August 1998): 23-26.

financial services industry were wrong. The Treasury Department, for example, estimated consumer savings from lower rates and reduces fees could amount to $15 B per year.[328]

Ultimately, perhaps reflecting the changing regulatory consensus, but certainly driven by the lobbying power of the financial services industry, the industry viewpoint won out in Congress. For example, Representative John A. Boehner, R-OH, claimed, “These historic reforms will mean far greater security and freedom for every American consumer.”[329] However, the issues raised in the Judiciary Committee and by consumer advocates more generally did have one lasting impact. That is, they found a receptive ear in Jim Leach, who was a long-time advocate of community banks. He later raised these same concerns to justify steps taken in H.R. 10 to protect small business, community banking, and agrarian interests.[330]

Defining Issues and Political Considerations

Five major categories of issues emerged as the debate over the repeal of Glass-Steagall shifted from the regulatory to the legislative arena in the 105th Congress. Two of these issues, functional regulation and bank operating structures, later became major defining aspects of the Gramm Leach Bliley Act. Two other categories had a significant impact on the shape of the debate but ultimately were removed from consideration for the final law. Those discussions were about mixing banking and commerce, including the thrift charter, as well as the “common bond” issue. Finally, another category of consumer protection issues emerged as congressional Democrats and the Clinton Administration

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[328] Lori Nitschke, “GOP Touts ‘One-Stop Shopping’ As Key Benefit of Overhaul Bill,” *CQ Weekly* (March 21, 1998): 728–30.

[329] Nitschke, “GOP Touts ‘One-Stop Shopping’ As Key Benefit,” 728–30.

[330] James A. Leach, Working Papers (2009/2010), Copy provided to Timothy J. Galpin on 20 November 2017, 4.

attempted to moderate the effects on individual consumers of creating large financial institutions. These issues included extension of the Community Reinvestment Act (CRA) beyond banking and protecting the privacy of consumers' financial data. Overall, the introduction and in some cases resolution of these five issue categories were the salient outcome of the legislative debate in the 105th Congress as it set the stage for the eventual passage of GLBA in 1999.

Functional Regulation

The legislative debate over financial services modernization brought to the fore the divergence of institutional and functional approaches to financial services regulation. Banking regulators and bankers benefited from the structure of federal banking laws, which assigned to bank supervisors the oversight of all financial activities at banks.[331] This institutional approach stood in contrast to the functional oversight of securities and insurance activities, which were generally applied at both the federal and state level to markets and market participants, except banks. Some compromise over the approach to be taken to the regulation of integrated financial institutions was necessary in order to advance financial modernization legislation, which had the effect of narrowing the scope of the legislation to focus on the repeal of Glass-Steagall. It is not well understood that the functional regulation compromise actually adopted in GLBA also had the effect of preserving many existing regulatory relationships. As will become clear below, the

[331] See Appendix 3. The National Bank Acts of 1863 and 1864, The Federal Reserve Act, The Banking Act of 1933, and The Bank Holding Company Act of 1956 as amended are among the relevant laws.

practical impact of repealing Glass-Steagall was much less deregulatory than it appeared because the existing federal and state regulatory agencies retained their authority.[332]

By 1997, broadly speaking the leaders of the securities and insurance industries were willing to accommodate the expansion of banks into their markets but only if the securities and insurance activities of banks were regulated in the same way and by the same agencies. Wayne Abernathy, lead professional staffer for the Senate Banking Committee, observed that the policy community, including bankers, quickly recognized functional regulation as an organizing principle around which the law could be built. While adoption of the functional regulation compromise for banking products had the potential to significantly alter banking regulation, bankers believed they could limit the impact. In effect the promise of the compromise brought the securities and insurance industries to accept the repeal of Glass-Steagall, but in practice there would be little change to the underlying regulatory structure.[333]

The actual choice of functional regulation as the compromise approach was largely driven by a desire to preserve key relationships between the insurance industry with its state regulators as well as the securities industry with the SEC. Both the securities and insurance industries had long-established tradition of government regulation through private self-regulating organizations (SROs). For example, the SEC partnered with the

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[332] In addition to the McFadden Act of 1927 and the Securities Act of 1933, various state insurance and securities laws were relevant. For example, see https://www.naic.org/documents/consumer_state_reg_brief.pdf for a summary of the history of state insurance laws. Accessed 26 October 28, 2018.

[333] Wayne Abernathy, Interview, January 23, 2018; Raymond Natter, Interview, February 22, 2017. In a separate discussion, Natter explained that functional regulation was actually a significant concession by the Federal Reserve. Their prior position had been that if the subsidiary was under the holding company it was subject to the jurisdiction of the Federal Reserve.

National Association of Securities Dealers and the stock exchanges. Similarly, the state insurance commissioners partnered nationally through the National Association of Insurance Commissioners (NAIC) to create regulations and model regulatory bills. As a result, the securities and insurance industries were unwilling to consider the more direct regulatory model under which the banking industry was supervised. In other words, SEC Commissioner Levitt as well as state insurance and securities commissioners took the position that insurance and securities activities by banks must be regulated functionally and not by, or not just by, bank examiners because of the associational ties between the securities and insurance industries and their regulators.[334]

In one sense, the debate over functional regulation was merely a chapter in a decades-long effort by insurers to fight off federal regulation.[335] Insurance agents as a group were convinced by the *Barnett* decision in 1996, which held that the right of national banks to sell insurance in small towns was not subject to state law, that banking was coming to insurance sales. This decision caused them to adopt a new strategy to ensure that their livelihoods were preserved by forcing bankers to comply with the same state rules they faced. This issue led the Independent Insurance Agents of America (IIAA), which was previously opposed to allowing insurance sales in banking, to offer

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[334] Abernathy, Interview, January 23, 2018. Regarding functional regulation and the implied continuation of state supervision of insurance, Abernathy noted that the negotiators recognized that they were not bringing the insurance industry as far along as they would like. Ideally the insurance industry would follow the same model the banking system. That is, charter insurance companies at both the federal and state level. This would not necessarily require a new federal regulator, but realistically would need some oversight if created a national pool to help customers whose national insurance company had failed (as state pools do for insurance companies now). In any event, the insurance industry was a long away from agreeing to something like a federal charter.

[335] Christy Ford Chapin, *Ensuring America's Health: The Public Creation of the Corporate Health Care System* (New York, NY: Cambridge University Press, 2015), 101-102 places the political role of insurance companies in context.

the breakthrough compromise in February 1997. Specifically, in order to move the debate forward, IIAA announced it would support financial services modernization legislation with the proviso that insurance activities were subject to functional regulation. In other words, the IIAA sought to retain state-level oversight of insurance activities even when those insurance activities were conducted by banks.[336]

The functional regulation compromise suggested by the IIAA was widely but not universally accepted. One of the few voices in strong opposition to the functional regulation approach was Ralph Nader, who argued it was not a viable solution, and that it certainly did not represent meaningful reform. In a letter to Presidential Advisor Gene Sperling, Nader presciently observed:

> Ironically, the proponents of H.R. 10 have made a bad regulatory system worse by giving in to industry whims to scatter regulation among a half dozen federal agencies and insurance, securities and bank regulators in the 50 states. It is certainly not a system to handle regulation of the new world of mega bank mergers much less the conglomerates contemplated in H.R. 10.[337]

Nader was arguing in favor of a fundamental restructuring of financial services oversight, however unlikely given the realities of the regulatory structure and the relationship between the regulatory communities and their respective industries.[338]

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[336] "On Capitol Hill: Outlook Brightens for New Banking Laws," *ABA Banking Journal* 89, No.2 (February 1997): 10.

[337] Ralph Nader, "Recommendation That Clinton Administration Oppose a Vote on HR 10 in the House of Representatives," Letter to Gene Sperling, Director National Economic Council (April 16, 1998). William J. Clinton Presidential Library & Museum.

[338] James Kwak, "Cultural Capture and the Financial Crisis," in *Preventing Regulatory Capture: Special Interest Influence and How to Limit It,* eds. Daniel P. Carpenter and David A. Moss (New York, NY: Cambridge University Press, 2014), 71-98. In the sense that there had been long-term relationships established, and both the industry players and their government oversight teams understood the rules of the game in their respective fields, the desire for functional regulation was a manifestation of regulatory capture.

Bankers as well as federal bank regulators were also somewhat skeptical about functional regulation, at least if implemented strictly along the lines of financial services product types. For example, the insurance agents' approach would logically call into question the role of the Office of the Comptroller of the Currency regarding insurance oversight.[339] State insurance commissioners, who regulated the sales of insurance by state-chartered banks, had no intention of ceding that authority to federal regulators. At the time, insurance selling by national banks was governed by the Office of the Comptroller of the Currency, which had been generally sympathetic to the banking industry's views. This became a key point of contention, as the insurance industry intended functional regulation to devolve to the state insurance commissioners for all insurance including insurance sales in banks, which the Treasury and OCC opposed.[340]

Similarly, both the securities industry and SEC argued that securities issued by banks or affiliates within bank holding companies should be regulated by the SEC. Bankers and bank regulators preferred instead to retain current authorities by the OCC and Federal Reserve over the types of securities being underwritten in banks.[341] Virgil Mattingly, for example, explained why the Federal Reserve would not accept a purely functional scheme with no Federal Reserve oversight of securities affiliates. He observed that the examples of Barings PLC and Continental Illinois demonstrated that within a holding company trouble at one affiliate could quickly spread to another. Also, while firewalls between affiliates within a holding company were important, they were not

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[339] Gary Semer and Matt Cooper, Professional Independent Insurance Agents of Illinois, letter to Senator Carol Moseley-Braun (D.-IL) and Senator Richard J. Durbin (D.-IL), September 9, 1998.

[340] "Opposing Views on Regulation of Banks' Insurance Sales," *Insurance Advocate* 109, no. 36 (September 12, 1998): 3.

[341] Nitschke, "Panels Inch Toward Deal," 539–40.

always effective. Hence the Federal Reserve argued it must always maintain some supervisory role over bank holding companies in order to fulfill its mandate of ensuring the safety and soundness of the banking system.[342]

Although the issue of functional regulation was not resolved at this point in the debate over the repeal of Glass-Steagall, overall the IIAA concession was pivotal because it set clear boundaries for what oversight the insurance industry leadership was prepared to accept. Asked about the meaning of the insurance agents' shift in position, Leach replied:

> It's an impressive change…the issue the insurance agents feel strongly about, and have an incredible case for, is the precept of state regulation of insurance. However, based on the Comptroller rulings, the insurance agents are apprehensive about the McCarran-Ferguson Act. That law authorizes state regulation of insurance without federal regulation. They are very concerned that there will be one federal regulator for one kind of institution selling insurance – banks – contrasted with their having to deal with all the state regulators…whatever decision is made it ought to be the same for all parties.[343]

Despite alternatives, Leach indicated that he would accept the position taken by the IIAA, saying, "For now it is appropriate for us to advance an approach that keeps state regulation of insurance."[344]

Given the reaction by Leach and other Congressional leaders, including House Speaker Newt Gingrich, R-GA and Majority Leader Dick Armey, R-TX, some form of functional regulatory scheme going forward was now clearly going to be part of any new

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[342] U.S. Congress, House Committee on Banking and Financial Services, "Financial Services Modernization: Hearings Before the Subcommittee on Financial Institutions and Consumer Credit of the House Committee on Banking and Financial Service," 105th Congress (1997): 441-442; Mattingly and Fallon, "Understanding the Issues Raised by Financial Modernization," 40-41.

[343] James Leach, interview in "One More Time," by Steve Cocheo, *ABA Banking Journal* 89, No.3, March 1997: 44.

[344] Cocheo, "One More Time," 44.

financial modernization law.[345] However, both Greenspan at the Federal Reserve as well as Ludwig and his successor Jack Hawke at the OCC took positions that ensured the functional regulation compromise was also likely to retain at least some historical regulatory relationships that were outside a purely functional schema. In fact, the eventual result of the legislative repeal effort was likely to hinge on how far the bankers would allow the law to undermine gains they had made by OCC and Federal Reserve interpretations of the law.

There is one final implication of the functional regulation compromise to consider. Although likely unintended, the strong preference of the securities and insurance industries for functional regulation was a significant impediment to the financial services modernization debate focusing on broader and more comprehensive reform. In other words, if repeal required functional regulation, and that demanded retention of current regulatory relationships, then as a consequence the financial deregulation effort would have to fit within the current regulatory framework. This meant that the law would be unlikely either to affect current relationships among the various financial industries and their regulators or the underlying regulations themselves. Thus, while the functional compromise was an enabling factor to allow the bill to proceed, it had the immediate impact of narrowing the range of options to focus more on repeal of Glass-Steagall and less on broader financial services reform.[346]

The impact of this delimitation was felt immediately as Congress considered other financial services reform issues. As will be discussed in Chapter 4, the commitment to retain the same functional relationships prevented genuine consideration of new

[345] Nitschke, "Panels Inch Toward Deal," 539–40.
[346] Abernathy, Interview, January 23, 2018.

arrangements such as oversight of OTC derivative markets or hedge funds. Indeed, when CFTC Chair Brooksley Born suggested an innovative approach to financial services regulation her peers at the Federal Reserve, Treasury, and OCC immediately turned against her.[347]

What this meant was that the functional compromise as proposed required the law to change in only one dimension: the repeal of the restrictions against affiliation among banking, securities, and insurance. And, as a practical matter, this narrowing in scope of the financial modernization meant that even if Glass-Steagall were repealed it would not necessarily affect the pre-existing regulations imposed by the respective regulators of banking, securities, or insurance. This concession to the status quo had the additional consequence of limiting consideration of new safety and soundness regulations necessary to account for the evolving financial markets that financial modernization was intended to address.[348]

Holding Companies versus Operating Subsidiaries

Just as the move towards functional regulation provided hope that a path to repeal Glass-Steagall could be found, another issue erupted between the Federal Reserve and Administration that was seemingly intractable. It was a dispute between the Federal Reserve and Treasury over the operating structure under which banks would be allowed to affiliate with securities and insurance firms. This disagreement nearly derailed the legislative effort to repeal Glass-Steagall by diverting significant attention from modern reform issues to focus on the lingering implications of New Deal banking regulation.

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[347] Phil Gramm, Interview, January 16, 2018. Senator Gramm said it was persuasive that all of her peers emphatically disagreed with Chairwoman Born.

[348] Cocheo, "One More Time," 44.

That is, leaders among banking regulators were focused on moral hazard, federal deposit insurance, and the federal payment system, which contributed to the failure of the financial services policy community to broaden its view of reform to include safety and soundness features for new markets and products.[349]

The Federal Reserve leadership argued for a structure in which the banks and any nonbank securities or insurance affiliates would all be subsidiaries of a holding company. The Treasury instead supported the concept that any such nonbank activities could be organized as operating subsidiaries of the bank itself. As will be discussed in more depth, this dispute was a bureaucratic turf war over whether the appointed Federal Reserve or the elected Administration would set banking policy. While it may have been that as well, each side actually argued the issue grounded in arcane issues associated with protecting the federal safety net for banks.[350]

Chairman Greenspan testified that financial modernization should not require that the federal risk subsidy be extended to other financial institutions besides banks. The subsidy at issue was the higher risk-adjusted rate of return that banks could generate on their equity compared to insurance and securities firms. Greenspan believed it was real. He characterized it as "an undesirable but unavoidable consequence of creating a safety net." Regarding financial services modernization, he reasoned that, "While a level

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[349] Laurence H. Meyer, "Issues in Financial Modernization," Remarks presented at the Conference on Financial Structure, the Jerome Levy Economics Institute of Bard College, Annandale-on-Hudson, New York (April 10, 1997): 1-8.

[350] The actual regulatory dispute would have been between the Federal Reserve, responsible for holding company regulation, and the OCC, responsible for national bank regulation. However, since the Comptroller of the Currency reported to the Treasury Secretary, the argument was that the elected officials would have oversight over bank policy, exercised through the OCC.

playing field (for banks, securities firms, and insurance companies) requires broader powers, it does not require subsidized ones." [351]

The federal risk subsidy issue was historically rooted in the deposit insurance created in response to the banking failures in the Great Depression, in combination with the federal payment system and access to the Federal Reserve as lender of last resort. Greenspan further testified that banks, "determine the level of risk-taking and receive the gains therefrom, but do not bear the full costs of that risk. The remainder of the risk is transferred to the government." The subsidy had a specific long-term impact on federal bank supervision. Greenspan explained that one consequence of the subsidy was "the necessity for the government to limit the degree of risk it absorbs by writing rules under which banks operate, and imposing on these entities supervision by its agents--the banking regulators--to assure adherence to these rules."[352]

In Greenspan's view the federal banking subsidy should not be extended to nonbank subsidiaries of bank holding companies in order to prevent the risks inherent in the businesses of securities and insurance being transferred to the commercial banking

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[351] Alan Greenspan, "Testimony before the House Banking Committee's Subcommittee on Financial Institutions and Consumer Credit," (February 13, 1997): 1-4.

[352] Greenspan, "Financial Institutions and Consumer Credit," 1-4 said: "In this century, the Congress has delegated the use of sovereign credit-the power to create money and borrow unlimited funds at the lowest possible rate--to support the banking system. It has done so indirectly as a consequence of deposit insurance, Federal Reserve discount window access, and final riskless settlement of payment system transactions. The public policy purpose was to protect depositors, stem bank runs, and lower the level of risk to the financial system from the insolvency of individual institutions. In insuring depositors, the government, through the FDIC, substituted its unsurpassable credit rating for those of banks. Similarly, provisions of the Federal Reserve Act enabled banks to convert illiquid assets, such as loans, into riskless assets (deposits at the central bank) through the discount window, and to complete payments using Federal Reserve credits. All these uses of the sovereign credit have dramatically improved the soundness of our banking system and the public's confidence in it."

system. Turning to the bank holding company structure versus the bank subsidiary structure issue for financial modernization, Greenspan argued that a bank operating subsidiary structure in which the bank directly owned securities and insurance subsidiaries would create greater risk to the banking system than a holding company structure.[353]

Greenspan pointed out that the Federal Reserve Act made it difficult to have a direct transfer of the safety net subsidy under the bank holding company structure. Not so if the nonbanking activities were held as operating subsidiaries of the bank rather than a holding company. In this regard, Greenspan specifically disapproved of the Comptroller's new Part 5 regulations that would permit banks to conduct nontraditional activities in bank subsidiaries. "The bank subsidiary may be a marginally more efficient way of delivering such services," he said, "but we (at the Federal Reserve) believe it cannot avoid being a funnel for transferring the sovereign credit subsidy directly from the bank to finance the new powers, thereby imparting a subsidized competitive advantage to the subsidiary of the bank."[354]

While Greenspan's position was widely held at the Fed, other banking regulators, especially those affiliated with the Treasury, disagreed. For example, FDIC Chairman Ricki Helfer testified, "If banks receive a net subsidy at all, it is small." She argued that the operating subsidiary model in which a national bank directly owned securities and insurance subsidiaries posed little if any additional risk to the banking system.[355]

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[353] Greenspan, "Financial Institutions and Consumer Credit," 1-4. This distinction between the bank and bank holding company is fundamental, but often misunderstood.

[354] Greenspan, "Financial Institutions and Consumer Credit," 1-4.

[355] Ricki Helfer, "Testimony before the House Banking Committee's Subcommittee on Financial Institutions and Consumer Credit," (February 13, 1997): 1-14. Helfer argued

Comptroller of the Currency Eugene Ludwig went further, arguing that Greenspan's premise was simply wrong; that is, banks do not receive a net subsidy, so there should be no concern with placing nonbank activities in operating subsidies reporting to a bank. Ludwig made two points to support his argument. First, there was no net subsidy because of other costs paid by banks. He testified, "Regarding deposit insurance… preliminary OCC research has found that the gross subsidy stemming from federal deposit insurance is roughly 4 basis points. That amount, however, is more than offset by the corresponding regulatory costs that banks bear, estimates of which range on the order of 22 to 30 basis points." Ludwig argued further that the gross subsidy, vice net subsidy, was greatly eroded in the 1990s. In particular, the FDIC Improvement Act of 1991 not only tightened terms under which banks could access the discount window, it also provided securities firms limited access to the window.[356]

It should be noted that both Helfer and Ludwig supported financial modernization, as did their boss Secretary of the Treasury Robert Rubin. It was just that this camp preferred a bank subsidiary structure to hold nonbank activities rather than a bank holding company structure. And while it is true that contemporary observers sometimes viewed this argument through the prism of bureaucratic turf wars (i.e., the Fed regulates bank holding companies while the OCC and FDIC regulate banks), the testimony here from Greenspan, Helfer, and Ludwig demonstrated that there was an underlying theoretical basis to the disagreement. And, more to the point, the dispute over

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that the difference in ratings was justified by the ratings agencies on the grounds that bank debt has priority in repayment over holding company debt both in debt servicing and in bankruptcy proceedings.

[356] Eugene Ludwig, "Testimony before the House Banking Committee's Subcommittee on Financial Institutions and Consumer Credit," (February 13, 1997):1-13.

the federal subsidy distracted the policymakers from considering other safety and soundness measures to be included in the law.

On a practical note, the deposit insurance subsidy argument had an inherent inconsistency. That is, to the extent that any new financial institutions, markets, and products were not regulated, but put commercial banks at risk as counterparties to these activities, the federal subsidy was in fact available to the other counterparties in the transactions. In other words, the firewall would be breached. The irony here is that Rubin and others missed the fact that both the operating subsidiary and bank holding company structures preserved a potential risk from systemically important financial institutions because they focused the argument about bank operating structure on the federal safety net. This is a crucial point because in focusing the debate on operating structure rather than systemic risk, both Greenspan and Rubin missed the opportunity to ensure that financial modernization addressed the "too big to fail" scenario.[357]

Resolving the dispute about using a holding company versus operating subsidiary structure was critical to allowing financial modernization to proceed. Although Greenspan had the support of the congressional committee chairs, as long as Rubin was Treasury Secretary he had President Clinton's support for a veto threat to win the point.[358] And Rubin remained intransigent. Indeed, some have speculated that given Rubin's subsequent departure for Citigroup he was biased in favor of the large banks on

[357] It would only be a year until that proposition was put to the test in the Long-Term Capital Management bailout, but went unremarked until the financial crisis of 2008-2009.

[358] U.S. Treasury, "Subsidiaries v. Affiliates," Department of the Treasury (May 12, 1998): 1-15. This document was written in response to a May 4, 1998 letter to Representative Dingell from Chairman Greenspan that transmitted a Federal Reserve paper on the issue.

this issue, but that seems unlikely. Instead, he appeared to be focused on ensuring that the prerogatives of the executive branch were preserved. Regardless, it would take two years until Congress finally ceded the issue to a compromise between Chairman Greenspan and Lawrence Summers, who succeeded Robert Rubin as Secretary of the Treasury.[359]

Mixing Banking and Commerce

The mixing of banking and commerce was another significant issue in the financial modernization debate. In this context, "commerce" meant a business activity that was nonfinancial in nature. Both securities and insurance were considered financial services businesses, not commerce. Hence, the debate about banking and commerce was not concerned with the separation of banking from insurance or securities.[360] Instead, the crux of the matter was about retail firms and banks owning each other, which was not allowed under the Bank Holding Company Act.[361]

House Banking Committee Chairman Jim Leach argued that the major change sought by lobbyists for the large commercial banks in 1997 was to break down the barriers between banking and commerce (e.g., allowing a Citi or Chase to merge with a Microsoft or Walmart). In making this claim, Leach was giving a nod to the significant

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[359] Robert E. Rubin, "Memorandum for the President: Financial Modernization Legislation," Secretary of the Treasury, March 15, 1998. William J. Clinton Presidential Library & Museum. For discussion of Rubin's move to Citigroup see James Freeman and Vern McKinley, *Borrowed Time: Citi, Moral Hazard, and the Too-Big-to-Fail Myth* (New York, NY: HarperCollins, 2018); "Ex-Treasury Secretary Robert Rubin Joins Company," *Citigroup World* 2, no. 5 (November 1999).

[360] Steve Cocheo, "Special Briefing: The Banking Commerce Debate," *ABA Banking Journal* 89, No.7 (July 1997): 8. Some observers attribute the separation of banking and commerce to the intent of Glass-Steagall, but it is actually spelled out in the BHCA of 1956.

[361] Nisreen H. Darwish, "The Mixing of Banking and Commerce: A Conference Summary," *The Federal Reserve Bank of Chicago*, no. 244a (November 2017): 4. One of the distinct advantages of the UTHC over bank holding companies was that retail firms could enter "banking" via thrift ownership while banks were not permitted to enter retail.

erosion of Glass-Steagall that already occurred in the administrative arena. Repealing restrictions on the affiliation of banking, securities and insurance would be at most a continuation of previous regulatory actions taken by the Federal Reserve and OCC. Having successfully blocked the commerce and banking issue from the Gramm-Leach Bliley Act (GLBA), Leach later observed, "If mixing commerce and banking had been approved, one could make a case that GLBA had changed dramatically the financial regulatory regime."[362] However, Leach opposed mixing banking and commerce because, "Such a change would have had the effect of concentrating wealth and economic power in America." He argued that the true heart of Glass-Steagall framework, including the BHCA, was to prevent such undue concentration.[363]

Reflecting later on the 1997 debates, Leach observed that many other leaders in the banking policy community were less opposed than he was to the concept of mixing banking and commerce. He recalled that:

> The leadership of both political parties in the House and the Senate, most of the leadership of the three committees of jurisdiction on both sides of the aisle in the House, including Barney Frank on the House Banking committee, and the Senate chairman of its Banking Committee (Senator D'Amato) supported this initiative. The only ally I had was Paul Sarbanes, D-MD, the ranking member of the Senate Banking Committee, despite the fact that mixing commerce and banking was also supported by the Clinton Administration's Treasury Department.[364]

This appeared to reflect a difference in emphasis. Other political leaders, and in particular the Democrats, focused on the promise of increased access to consumer loans and

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[362] James A. Leach, E-mail to Timothy J. Galpin, November 20, 2017; Ralph Nader, "Recommendation That Clinton Administration Oppose a Vote on HR 10 in the House of Representatives," Letter to Gene Sperling, Director National Economic Council (April 16, 1998). William J. Clinton Presidential Library & Museum.

[363] James A. Leach, E-mail to Timothy J. Galpin, November 20, 2017.

[364] James A. Leach, E-mail to Timothy J. Galpin, November 20, 2017.

ignored the concentration of wealth concern.[365] Although Leach was willing to accept some role for banking and commerce as part of an overall financial modernization package, his preference was that the commerce issue be dealt with by legislation separate from financial modernization, which he wanted to focus on repealing Glass-Steagall.[366]

The Clinton Administration did not take a strong position, but indicated a willingness to include the issue of banking and commerce in financial modernization legislation. In 1996, Congress directed the Treasury Department to recommend by March 1997 how to merge the banking and thrift charter. The Treasury delivered a long-awaited response in May 1997.[367] According to Gene Sperling, Director of the National Economic Council, “This proposal would satisfy a statutory requirement that the Secretary of the Treasury report to Congress by March 31, 1997 on how to harmonize and integrate the regulation of banks and thrifts.” However, the Treasury report did not live up to

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[365] James A. Leach, “Working Papers,” 2009/2010. Leach relays an amusing anecdote in which he explained to the heads of the major commercial banks they were making a mistake in assuming that in mixing banking and commerce that the banks would be driving the mergers and not the large retailers.

[366] Cocheo, “Calls OCC Gambit a Potential Monkey-wrench,” 39. Two specific factors drove proposals to merge the national bank and federal thrift charters. First, the 1996 Economic Growth and Regulatory Paperwork Reduction Act required that banks share in the final cleanup of the S&L industry. A corollary was that the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) would be merged by 1 January 1999 if the federal thrift charter was eliminated. These two factors became part of the conversation on financial modernization.

[367] John D. Hawke, Jr., “Treasury’s Draft Proposals for Financial Modernization,” Testimony before the Banking and Financial Services Committee, U.S. House of Representatives, Washington, D.C. (June 3, 1997); John D. Hawke Jr., “Treasury Under Secretary for Domestic Finance Remarks,” Testimony before the House Commerce Subcommittee on Finance and Hazardous Materials, Washington, D.C. (July 17, 1997) were substantially the same.

Sperling's rhetoric. Specifically, while it outlined options, it made no recommendations for legislation to deal with the commerce and banking issue.[368]

The issue of mixing banking and commerce was sometimes referred to as a merging of federal banking and thrift charters. This was because the federal thrift charter already allowed the mixing of retail and banking via unitary thrift holding companies (UTHC). For example, many retail companies as diverse as GE capital and Nordstrom Financial Services already owned UTHCs.[369] Hence, on the regulatory front proponents of mixing commerce and banking argued that doing so would merely ratify a current market reality and might have the advantage of bringing more capital into banking. This argument came from Office of Thrift Supervision studies that appeared to document cases of unitary thrift holding companies providing financial support to their S&L subsidiaries. Further, allowing banking affiliations with commerce was thought to level the international playing field, since such affiliations were a significant component of the portfolios for large multinational "universal" banks.[370]

For their part, bank regulators were generally opposed to allowing commercial banking to mix with commerce, but were also unresolved as to an appropriate approach within the financial modernization debate. Virgil Mattingly pointed out that in the U.S., the two were traditionally separated out of fear of a concentration of economic power in the hands of a relative few. In this regard, the unitary thrift exception was an unintended loophole that permitted industrial entities, commercial firms, insurance companies, and

[368] Gene Sperling, "Treasury's Proposed Financial Services Modernization Legislation," The White House (March 17, 1997). Courtesy of the William J. Clinton Presidential Library & Museum.

[369] "Special Report," *ABA Banking Journal* 91, No.12 (December 1999): 12-28.

[370] Cocheo, "The Banking Commerce Debate,"13.

broker-dealers to conduct banking through ownership of a single thrift. Note that under Glass-Steagall, these same conditions were not permitted for banks! Mattingly suggested that allowing some mixing would potentially expand the federal safety net by increasing risk to banks, but acknowledged others contended instead that risk to banks would actually be lowered through diversification. Finally, Mattingly argued that given the recent negative experience of Japanese firms, the Federal Reserve, FDIC, and OCC were all in agreement Congress should be cautious in this regard.[371]

Laurence Meyer, Federal Reserve Governor and chair of the Board's Committee on Supervisory and Regulatory Affairs, argued that the burden of proof for the change lay with proponents for increased mixing of banking and commerce. Advocates offered several arguments, from diversifying the business base of both, to increased capital for banking, to reducing the asymmetric information advantage of banks associated with commercial lending. However, Meyer rejected these asserted advantages. He commented, "Suffice it to say that I find each of them wanting. I can find very little, if any, in our experience as a nation that gives me real confidence about the benefits of combining banking and commerce."[372]

Legislative Wrangling: The Fractured Process

Unable to come to any consensus in the first session of the 105th Congress, both the House Banking Committee and House Commerce Committee deferred action on the financial services modernization bill (H.R. 10). The second session of the 105th Congress

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[371] Mattingly and Fallon, "Understanding the Issues Raised by Financial Modernization," 33. The Japanese comment addressed the recent "Asian Contagion" that was attributed partly to the close relationship of Japanese commercial firms to their banks, sometimes referred to as the *zaibatsu*.

[372] Meyer, "Issues in Financial Modernization,"1-8.

opened in 1998 with high hopes that the House could reach a compromise on financial modernization that would be supported by the banking, securities, and insurance industries, as well as the regulatory community. House Speaker Newt Gingrich, R-GA, and Majority Leader Dick Armey, R-TX, set a deadline of March 4 for the members of the House Banking and House Commerce committees to reconcile the competing versions of H.R. 10 that each committee passed in 1997.[373]

Sensing the possibility of the House passing a bill for the first time, the Administration and the regulatory agencies engaged heavily with Congress to shape the outcome. Optimism for a bill aside, Congressional Republican leaders had to contend with significant opposition among their Democratic counterparts, especially John LaFalce, D-NY, and John Dingell, D-MI, reflecting a desire to protect consumers. Even so, the Republican leadership notified the representatives of the banking, securities, and insurance industries that it would make a major effort to pass the bill. Lobbyists from all three financial services industries set themselves to defend their respective positions, indicating that significant work remained in order to reach consensus.[374]

Early in 1998, after both the House Banking and Commerce Committees delivered differing versions of H.R. 10, House Speaker Newt Gingrich, R-GA, and Majority Leader Dick Armey, R-TX, designated a Financial Services Working Group to build consensus around a version of H.R. 10 that could be brought to the floor for a vote. The working group was led by House Republican Conference Chairman John Boehner,

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[373] Laurence H. Meyer, "The Federal Reserve and Bank Supervision and Regulation." Remarks presented at the Spring 1998 Banking and Finance Lecture Widener University, Chester, PA (April 16, 1998): 1-12.

[374] Nitschke, "Panels Inch Toward," 539–40.

R-OH, and included other leaders from the House Banking and Commerce Committees.[375]

The compromise draft version of H.R. 10 that emerged from negotiations within the Financial Services Working Group allowed banks, securities firms, and insurance companies to affiliate with each other within certain limits. This, along with the functional regulation compromise, met the basic requirements of the securities firms and insurance companies to level the playing field with commercial banks. It further codified the authority of national banks to sell insurance products granted in *Barnett*. Although, in a victory for insurance agents, it required the banks to submit to state oversight of insurance sales, which was not currently required by the courts.[376] This version of H.R. 10 also created a new category of financial holding company that could be set up by banks to sell securities, but would be regulated by the SEC. Finally, as written H.R. 10 would not immediately phase out the unitary thrift loophole that currently allowed commercial companies and insurance companies to start or acquire a single thrift. [377]

The securities and insurance industries were staunchly in favor of the compromise draft H.R. 10. bill. However, on 23 March 1998, the powerful ABA announced its opposition, calling into question its chances of success even if Republican leaders brought the compromise bill to the floor by the end of the month as promised. The

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[375] "Financial Services Working Group," *ABA Banking Journal*, Vol 89, No.10 (October 1997): 12.

[376] *American Ins. Ass'n v. Clarke*, 865 F. 2d 278 - Court of Appeals, Dist. of Columbia Circuit 1988, the "AMBAC case;" *Nat. Ass'n Of Cas. & Sur. Agents V. Bd. Of Gov.*, 856 F. 2d 282 - Court of Appeals, Dist. of Columbia Circuit 1988, the "SOVRAN and Maryland National (MNC) case;" and *Independent Ins. Agents of Am. v. Bd. of Governors*, 835 F. 2d 1452 - Court of Appeals, Dist. of Columbia Circuit 1987.

[377] Lori Nitschke, "Banking: House Deal Offers Bit of Hope for Glass-Steagall Overhaul," *CQ Weekly* (March 14, 1998): 647–49.

banking community was somewhat divided on the issue. ABA leadership offered to continue to work with Congress on the bill, while America's Community Bankers (ACB) pronounced the bill to be "so badly flawed it cannot be fixed." Even among the large banks typically represented by ABA some, such as Banc One and Nationsbank, supported the measure while others, notably Citicorp, opposed it.[378]

Despite some disagreement within the ranks, bankers generally believed that the bill would erode their competitive advantage, won through long years of regulatory and court victories, over securities and insurance firms. Republican leaders fueled bankers' opposition when they scaled back previous plans, strongly supported by the bankers, for H.R. 10 to eliminate the unitary thrift charter. Ultimately, Edward Yingling, chief lobbyist for the powerful ABA stated categorically that, "there's nothing in this bill" for the banking community.[379]

One additional complication was that the committee chairs and House leaders remained undecided on whether or not to move the bill with a legislative fix to the Supreme Court's "common bond" decision on February 25, 1998.[380] This decision, which narrowed the permissible membership of credit unions to groups with a common bond (e.g., federal workers, or pipefitters, etc.), was important to credit unions and bankers but

[378] "Bankers' Group Opposes Bill," *CQ Weekly* (March 28, 1998): 807. Note that this is before the announcement of the Citicorp-Travelers merger, after which both Citicorp and Travelers became strong supporters of Glass-Steagall repeal.

[379] Lori Nitschke, "House Floor Says 'No Thanks' to Financial Services Bill," *CQ Weekly* (April 4, 1998): 864–66.

[380] *National Credit Union Admin. v. First Nat. Bank & Trust Co.*, 522 US 479 - Supreme Court 1998. The ruling was that the National Credit Union Administration's (NCUA) interpretation of Section 109 of the Federal Credit Union Act (FCUA 12 USC §1759) violated the unambiguous meaning of the law, which clearly states a common bond is required among members. In response, Congress later enacted the Credit Union Membership Access Act (CUMAA) explicitly authorize multiple common bond federal credit unions.

peripheral to the repeal of Glass-Steagall. Bankers supported the Supreme Court decision, but Congress was under heavy lobbying pressure from credit union trade associations to override the Supreme Court and restore an expansive view of credit union membership. After one abortive attempt to include the common bond fix in the draft H.R. 10, the two issues were separated. A stand-alone credit union fix was passed on 7 August 1998 as the Credit Union Membership Access Act.[381] This law resolved a significant distraction for financial modernization, and returned attention of the policy community to the repeal of Glass-Steagall in late 1998.[382]

Finally, the Clinton Administration rejected the compromise House draft H.R. 10. One concern for the Administration was that it did not advance the Democratic agenda on community reinvestment. Community activists and Democrats typically favored community reinvestment provisions as a way to force private capital into underdeveloped communities. The Clinton Administration and Democrats wanted to leverage H.R. 10 to expand the provisions of the 1977 Community Reinvestment Act (CRA) to insurance companies and securities firms.[383] Republicans on the other hand generally opposed such efforts as market interference, and often sought to minimize the applicability of the CRA to small banks.[384]

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[381] PL 105-219; 112 Stat. 913.

[382] Lori Nitschke, "Credit Union Bill Sails Solo," *CQ Weekly* (April 4, 1998): 865.

[383] Ralph Nader, "Recommendation That Clinton Administration Oppose a Vote on HR 10 in the House of Representatives," Letter to Gene Sperling, Director National Economic Council (April 16, 1998), William J. Clinton Presidential Library & Museum; Jo Ann S. Barefoot, "Caught between two worlds," *ABA Banking Journal* 90, No. 3, March 1998: 32. The CRA, PL 95-128, originally enacted in 1977, had major revisions in 1989, 1991,1992, 1994, and 1995. It was the latter revision which sought to reduce the cost and compliance burden of CRA examinations.

[384] Nitschke, "No Thanks," 864–66.

In addition to the community reinvestment issue, Treasury Secretary Rubin was concerned that this version of H.R. 10 did not accommodate the operating subsidiary organizational construct. While the staffs at the White House and Treasury agreed with Rubin, it was the Secretary who personally proposed to President Clinton that the time was right to come out against the House Republican leadership's version. Despite some strategic considerations for allowing the bill to pass the House and seek improvements in the Senate or in conference, Rubin recommended stopping this version in the House. His point was that, "The Senate may well not act on the proposal this year and a House-passed bill might then become the baseline for the next Congress." This was a purely tactical decision that was designed to allow the Administration room to negotiate additional CRA concessions in support of its community activist base. And, for Rubin personally, it allowed him to reject a draft bill that did not accommodate his preference on operating structure.[385]

That is not to say the bill was completely flawed from the Administration's perspective. Rubin acknowledged that it met many of the Administration's goals. However, he saw several of its provisions as a direct challenge to the OCC's Part 5 initiative to expand the power of national banks through operating subsidiaries, and found the exclusion of operating subsidiaries from H.R. 10 to be unacceptable. As a result, President Clinton signed out a Statement of Administration Policy that doomed the bill in its current form.

> The Administration strongly opposes the House Republican Leadership substitute for H.R. 10 because it would: (1) stifle innovation and efficiency in the national

[385] Robert E. Rubin, "Memorandum for the President: Financial Modernization Legislation," Secretary of the Treasury (March 15, 1998): 1-3. William J. Clinton Presidential Library & Museum.

> banking system; (2) diminish the ability of communities and consumers to benefit from the financial system; (3) eliminate advantageous features of the current thrift charter; and (4) impose needless costs on small banks.[386]

In effect, the Administration was putting the Congress on notice that it would oppose any bill that foreclosed the possibility of operating subsidiaries as an organizational construct. This was really a bureaucratic dispute between the Treasury, OCC, and FDIC on one hand and the Federal Reserve on the other. Recall that the bankers themselves were generally neutral about the operating construct solution. President Clinton was supporting Rubin by contending that, "A bank that wished to avail itself of new powers would thus have to transfer capital to an affiliate, thereby depleting the bank's resources and shifting any earnings benefit from the bank to the affiliate." The Administration also laid down a strong if subtle position on community reinvestment that was related to the operating subsidiary issue. Clinton argued that the holding company affiliate structure would force "financial innovation to occur in holding company affiliates rather than in bank subsidiaries." Since the CRA did not apply to holding companies, only to banks, this would have the practical effect of moving many financial activities into affiliates with no obligation to ensure community reinvestment.[387]

Given that to date the House had never passed a bill to repeal Glass-Steagall, House Republican leaders fought hard to bring the bill to a vote. Commerce Committee Chair Thomas J. Bliley Jr., R-VA, stated that, "If we stop it tonight…there will be no bill this year." However, despite efforts by the leadership to bring the bill to the floor, Rules Committee Chair Gerald B.H. Solomon, R-NY, pulled the measure when it became

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[386] William Jefferson Clinton, "Statement of Administration Policy: H.R. 10 - Financial Services Act of 1998," The American Presidency Project, March 30, 1998.

[387] Clinton, "Statement of Administration Policy, March 30, 1998.

apparent that H.R. 10 could not pass in the face of a determined lobbying effort by the banking community, unified opposition by the House Democrats, and strong objections from the President.[388]

Turning the Tide: The Citicorp-Travelers Merger

In parallel with Congress embarking on a concerted effort to pass financial services modernization legislation, the Citicorp-Travelers proposed merger represented the culmination of the regulatory and judicial campaign to undermine Glass-Steagall. The approval of this merger in 1998 serves as a case study for the extent to which the Federal Reserve was willing to push the boundaries of the law. At the time the merger received much attention for its audacity, sheer size, and apparent conflict with the law.[389]

In one sense, the Citicorp-Travelers merger was just another in a long line of Federal Reserve and OCC approvals of bank requests for regulatory interpretations that pushed back the boundaries of Glass-Steagall.[390] Co-CEOs Sandy Weill and John Reed

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388 Lori Nitschke, "House Floor Says 'No Thanks' to Financial Services Bill," *CQ Weekly* (April 4, 1998): 864–66.

389 The Citigroup merger formed the largest financial services company in the world to date. Sandy Weill, who in 1988 merged Commercial Credit with Primerica, which owned Smith Barney, added Travelers Insurance in 1993, bought Solomon Brothers in 1997, and finally partnered with John Reed at Citicorp in 1998 in a "merger of equals" to create Citigroup.

390 "OCC Rulings," *ABA Banking Journal* 90, No.1, January 1998: 8. The OCC was every bit as aggressive as the Federal Reserve. After having modified its Part 5 regulations in 1997 to permit national banks to engage in previously unallowable activities via subsidiaries, with approval of the OCC, the OCC issued its first approval in December 1998. Specifically, Zions First National Bank was granted permission to underwrite municipal revenue bonds through an operating subsidiary. The OCC specifically concluded that underwriting and dealing in revenue bonds was part of the "business of banking." The OCC also relied on previous interpretations of Section 20 of the Glass-Steagall Act, long since accepted by the courts, that affiliates and subsidiaries of banks could underwrite and deal in securities as long as they were not "principally engaged" in the securities activity. It is also helpful to note that the OCC actually took a relatively conservative stance here by requiring that Zions be insulated from the

argued that they were simply seeking efficiencies among their two businesses. Indeed, before the merger was proposed with Citicorp, the Travelers had already received permission from the Office of Thrift Supervision to form its own unitary thrift holding company (UTHC).[391] This was set aside in favor of the Citigroup deal. However, the key difference between a Travelers that owned a UTHC and a Travelers merged with Citicorp, other than sheer size, was that the Citigroup merger was a clear violation of the original intent of Glass-Steagall. So, in another sense, the fact that the Federal Reserve approved this merger meant that the legal prohibition against affiliations among banks, brokers, and insurers no longer had any practical meaning.

The implications of the Citigroup merger were profound and affected virtually every aspect of the legislative campaign to repeal Glass-Steagall. This is not to imply that the merger guaranteed a particular outcome in the legislative debate. However, it did serve demonstrate the extent to which the ideological consensus had shifted, and it also served as a catalyst for further legislative action.

From a historical perspective, one interesting question was if Travelers CEO Sandy Weill, Citicorp CEO John Reed, Federal Reserve Chairman Alan Greenspan, and Chief Counsel Virgil Mattingly, either singly or jointly sought the merger to force Congress to pass financial services modernization. As we will see, it appears that the answer was yes, as long as the merger could be consummated within boundaries consistent with positions taken previously by the Federal Reserve. Regardless, it had that

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underwriting activities of its subsidiary by requiring the subsidiary to maintain its own capital reserves. Hence, the Citicorp-Travelers merger approval by the Federal Reserve is touted as the seminal decision.

[391] Steve Cocheo, "A Closer Look at Unitary Thrifts," *ABA Banking Journal* Vol. 90, Issue 10, October 1998: 64-72.

effect. That is, the merger forced Congress to act in order to either realign the law governing the financial services industry with the effective state of the regulation, or instead force the largest and most powerful American financial institution in the world to unwind itself.

A Call to Action

Many in the insurance industry expected that the Traveler-Citicorp merger would in fact cause Congress to modernize the law. David Pratt, American Insurance Association senior vice president of federal affairs noted, "This deal is a crystal-clear example of how the financial services market is light-years ahead of the law…it should boost the chances of Congress passing financial services modernization this year."[392]

For Jim Leach, Chairman of the House Banking Committee and long-time advocate of financial services reform, the announced merger definitely was a call for Congressional action. He stated that the Citicorp-Travelers merger, "Underscores the need for prompt congressional action on financial services modernization legislation to ensure that America's competitive position abroad is enhanced with proper functional regulation at home." On 8 April 1998, after his most recent draft of H.R. 10 was pulled from the House floor for lack of support, Leach added with some frustration towards the Federal Reserve, that regulators, "Appear to be willing to allow a truck to be driven through provisions of the Bank Holding Company Act which were designed to allow the orderly divestiture of minor non-conforming activities in bank holding companies."[393]

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[392] David Pratt, "Citicorp, Travelers Group Intent to Merge Announcement," *Insurance Advocate* 109, no. 15 (April 11, 1998): 1.

[393] James A. Leach, "Citicorp, Travelers Group Intent to Merge Announcement," *Insurance Advocate* 109, no. 15 (April 11, 1998): 1; Interview, Unnamed Source, 2017. In this related interview an observer who asked to remain unidentified called the Federal

Structure of the Deal

Citicorp and Travelers applied on 1 May 1998 to the Federal Reserve Bank of New York to form a bank holding company and merge. The request was received on 4 May 1998.[394] The merger was unprecedented on several grounds. First, the combined companies were valued at $70 billion and had combined assets of approximately $700 billion. Statistically, Citigroup would have 100 million customers in 100 countries; net revenues of approximately $50B; and operating income of $7.5B. It would be the largest financial services company in the world by market capitalization.[395]

Citicorp and Travelers asserted that the merger was premised entirely on the business value of the new combined company. A company briefing stated that merging into Citigroup would create the leading global financial services company, with the major value added being the cross-selling opportunities.[396] Citicorp and the Travelers also framed the merger in terms of its value to customers. According to the application, "Citi consumer and commercial customers will have the opportunity conveniently and

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Reserve's logic in approving the merger "obscene." His point was that the Section 20 exceptions had never been intended for deliberate mergers. Instead, they were intended to allow a period of time for banks that had mergers for other business purposes to sell off residual noncompliant activities such as insurance agencies or securities operations.

[394] Jay B. Bernstein, "FRB Receipt of Travelers Request to Form Bank Holding Company as a Result of Merger with Citicorp," May 11, 1998. Citi Heritage Collection, RG3, Box 26, Accession 2005-00.

[395] "Citigroup Press Release," April 6, 1998, Citi Heritage Collection, RG7, Box 22, Accession 2005-00; "Fact Sheet" Citigroup, April 6, 1998 Citi Heritage Collection, RG5, Box 24, Accession 2005-00.

[396] "Citigroup Corporate Data Briefing," April 1998, Citi Heritage Collection, RG3, Box 26, Accession 2005-00; "Compilation of Press Commentary about Weill," Various, April 1998. Citi Heritage Collection, RG5, Box 24, Accession 2005-06.

efficiently to purchase a range of banking, insurance, and security products, whether at a bank, insurance agency, or securities brokerage."[397]

Although the two companies scrupulously avoided any suggestion that the deal was premised on Congress repealing Glass-Steagall, it was reasonable to make that assumption. For example, a number of modifications were known to be required to merger the companies and comply with the current law and regulatory structure. Traveler's Robinson-Humphrey brokerage revenues appeared to violate section 20 restrictions on earning more than 25% from underwriting commercial securities within a subsidiary, which would have to be reduced. Also, to comply with rules that limited loans to affiliates, the parent holding company would need to stop making unsecured loans to the Travelers insurance subsidiary, and force Travelers to limit or collateralize currently unsecured lines of credit. Finally, the two companies acknowledged that current law gave the merged bank holding company two years, and potentially five years with extensions, to divest insurance underwriting units. Therefore, if Congress did not repeal Glass-Steagall Citigroup would have to divest its insurance underwriting companies (i.e., Primerica Life Insurance Co, Travelers Insurance Co, and Travelers Life and Annuity Insurance Co).[398]

All that said, prospective co-CEOs Reed and Weill did specifically envision that they could convince Congress to modify the law. As they jointly announced, "Citicorp

[397] The public portions of the joint Citicorp-Travelers application (244 of 8000 pages) were Public Volumes I-XI and CRA Public Volumes I-III. Cf. Jeffrey A. Watiker, "Citicorp HDMA Reporting Subsidiaries'1997 HDMA LAR," May 11, 1998, Citi Heritage Collection, RG3, Box 26, Accession 2005-00.

[398] Jaret Seiberg, "Citi, Travelers Assert Deal's Legality," *American Banker*, May 5, 1998, Citi Heritage Collection, RG6, Box 21, 2013-06; Jay B. Bernstein, "FRB Receipt of Travelers Request to Form Bank Holding Company as a Result of Merger with Citicorp," May 11, 1998. Citi Heritage Collection, RG3, Box 26, Accession 2005-00.

and Travelers Group expect that current laws restricting bank holding companies from participating in insurance underwriting activities will change in the foreseeable future to make the U.S. more openly competitive in global markets." But the crucial point from their perspective was that they sought to change to law to support the success of their merger; they did not merge in order to change the law.[399]

Financial Services Industry View of the Citigroup Merger

Most large financial services firms favored the merger if only because it would force Congress to finally streamline financial services laws to more easily enable banks, insurance companies, and securities firms to affiliate and sell each other's products. While these various types of institutions could already sell each other's products due to the long-term deregulatory trend among Federal regulatory agencies, notably the Federal Reserve and OCC, doing so still required complex organizational structures and legal fictions. In other words, there was still value in codifying the regulatory changes in law from the perspective of the financial services industry.[400]

However, the financial services industries were not united in approval of the merger. Smaller banks and some insurance companies argued if the Federal Reserve approved the Citigroup deal without Congress changing the underlying legal framework that would provide an unfair competitive advantage to the newly merged company. At least one industry association, the Independent Bankers Association of America (IBAA), which represented small bankers, strongly opposed Fed approval of the deal on exactly that issue. As IBAA executive Rob Rowe stated, "In a functioning democracy, the

[399] "Citigroup Press Release/Fact Sheet," April 6, 1998, Citi Heritage Collection, RG7, Box 22, Accession 2005-00.

[400] Troy L. Wilson, "Citicorp-Travelers Merger/HR10," April 29, 1998, Citi Heritage Collection, RG3, Box 26, Accession 2005-00.

Congress should not permit regulators to do something by regulation that the Congress could not secure by the passage of legislation."[401]

Indeed, the IBAA was among the most vociferous and cogent critics of the Citigroup merger. Executive Vice President Kenneth A. Guenther laid out his case in a letter to Chairman Greenspan. The argument was that the merged company would be so large as to change the financial landscape of the United States. IBAA argued that the size alone should give the Federal Reserve pause and caution should dictate deference to the on-going Congressional legislative attempts to amend Glass-Steagall and the Bank Holding Company Act.[402]

Charges of Illegality and Collusion

The IBAA continued its opposition to the merger in its public comments, contending that the merger was illegal as well as bad policy.[403] According to the IBAA's regulatory counsel Karen Thomas: "Contrary to their belief, Citigroup may not use the divestiture portions of the BHC Act to warehouse its insurance activities for up to five

[401] Kathleen Day, "Citicorp-Travelers Deal on Track," *Washington Post*, September 22, 1998, Citi Heritage Collection, RG7, Box 22, Accession 2005-00.

[402] Kenneth A. Guenther, "IBAA Concerns About Citigroup Merger," April 14, 1998, Citi Heritage Collection, RG3, Box 26, Accession 2005-00. However true the IBAA claim about the original intent of the law, by 1998 the courts had made clear that they would defer to the Federal Reserve's position on this matter. Additionally, the criticisms based on size became less relevant as the Federal Reserve continued to approve large scale mergers.

[403] Pamela P. Flaherty, "Feedback from the Federal Reserve Bank Public Meeting, June 25-26," Citicorp Global Community Relations, August 3, 1998, Citi Heritage Collection, RG6, Box 20, Accession 2013-06.

years while hoping for a change in the law. The divestiture provision is not available to a company with no honest intent to divest."[404]

The IBAA was supported in its position by community activist Mathew Lee, the executive director at Inner City Press/Community on the Move (ICP). In the first place, Lee contended that the Glass-Steagall and BHC acts prohibited bank holding companies from owning or controlling insurance and securities underwriting businesses, which the merged Citigroup bank holding company would in the form of Travelers insurance and Solomon Smith Barney subsidiaries. Second, Lee argued, "The crucial point is that this merger is illegal. The merger is designed to evade the current law which the Fed has a duty to uphold...The purpose of the two-year waiver is to sell the business off as soon as possible."[405]

ICP also was among the most persistent in the singular charge that prior meetings among Federal Reserve Chair Alan Greenspan, Chief Counsel Virgil Mattingly, as well as CEOs John Reed and Sandy Weill constituted collusion for prior approval of the Citigroup merger, without the due process of public discussion. ICP discounted public statements by Fed officials that the meetings were routine and provided no prior approval. [406]

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[404] Karen Thomas, "IBAA Sideswipes Banking Law," *Independent Bankers Association of America*, June 25, 1998, Citi Heritage Collection, RG6, Box 20, Accession 2013-06.

[405] Mathew Lee, "ICP Letter in Opposition to Citigroup Merger," April 13, 1998, Citi Heritage Collection, RG3, Box 26, Accession 2005-00. Mary Kelleher, "Citicorp-Travelers Merger Plan to Face Public Eye," Yahoo - Reuters, June 24, 1998, Citi Heritage Collection, RG6, Box 20, Accession 2013-06.

[406] William W. Wiles, "Federal Reserve Response to FOIA Request by Mr. Mathew Lee," May 11, 1998, Citi Heritage Collection, RG3, Box 26, Accession 2005-00; Mathew Lee, "FOIA Request for Information Related to Messrs. Reed/Weill Briefings of Chairman Greenspan," April 13, 1998, Citi Heritage Collection, RG3, Box 26, Accession

Lee cited material from two letters to demonstrate counsel for Citicorp and Travelers, Bradley Sabel and William Sweet, obtained prior approval from Fed chief counsel Virgil Mattingly for a specific way of constructing the merged company. The letters discus an approach to cross-marketing among the Citicorp's banking and Travelers' insurance subsidiaries. Sabel and Sweet then "ask that you advise us if you (Mattingly) disagree with the approach and analysis we have outlined in this letter." The second letter clearly refers to a subsequent phone call with Mattingly, then confirms in writing Sabel and Sweet's understanding that cross-marketing would be permitted as long "as it does not impede or impair the combined company's ability to divest the insurance companies, as required."[407]

A full reading of the joint Sabel-Sweet letters to Mattingly are much less ominous than the ICP contends. The counsels for Citicorp and Travelers make clear that the prior meetings among Reed, Weill, Mattingly and Greenspan on 25 March 1998 were concerned with matters of law and precedent. The CEOs sought reassurance that their legal interpretation was correct; that is, the merger was allowed as long as impermissible activities were divested as required by law meaning, in this case, within two to five years.

2005-00; B. Rehm, "Megamerger Plan Hinges on Congress," American Banker, April 7, 1998; "Travelers, Citicorp Chairmen Confident of Merger Federal Approval," Agence France Presse, April 6, 1998.

[407] Mathew Lee, "Freedom of Information Act Appeal," Inner City Press Community on the Move & Inner City Public Interest Law Center, May 15, 1998. Citi Heritage Collection, RG3, Box 26, Accession 2005-00; Bradley K. Sabel and William J. Sweet Jr., "Letter to Virgil Mattingly Regarding Federal Reserve Interpretations of Permitted Activities," March 30, 1998. Citi Heritage Collection, RG3, Box 26, Accession 2005-00; Bradley K. Sabel and William J. Sweet Jr., "Letter to Virgil Mattingly Confirming Federal Reserve Interpretations of Permitted Activities," March 31, 1998. Lee undermines his point in footnote 2 on p. 2 of the FOIA rebuttal when he cites a conversation with a long-time banks lawyer about these two letters, who said that "some practitioners before the FRB believe that, as long as the FRB does not put anything in writing, this seeking of pre-approval is acceptable."

Greenspan and Mattingly replied that was correct with the caveat that the corporate structure had to treat the divestiture matter in good faith; that is, the merger had to proceed as if the divestiture would happen and not count on legislative changes to make the insurance affiliation permissible.[408]

In the end, rather than evidence of collusion among Reed, Weill, Greenspan, and Mattingly, the Sabel-Sweet letters demonstrated prudent and accepted legal practice to lock down common understanding from a meeting. Counsel for Citibank and Travelers merely sought assurance that their intended course would not be considered by the Federal Reserve as crossing the line into impermissible activities. After all, if that were the case, the business proposition for the merger would have been invalid, which would have been cause for Weill and Reed to call off the merger.

To support this point, Weill and Reed held parallel conversations subsequent to meeting with Greenspan, in order to lay the groundwork for the approval process with Treasury Secretary Robert Rubin, members of Congress, the President's Council of Economic Advisors, and even President Clinton.[409] Although much is sometimes made of

[408] Bradley K. Sabel and William J. Sweet Jr., "Letter to Virgil Mattingly Regarding Federal Reserve Interpretations of Permitted Activities," March 30, 1998. Citi Heritage Collection, RG3, Box 26, Accession 2005-00, pp. 1-2; Kenneth Bialkin, Interview, November 20, 2017, retained by author. Although present for the discussions, Mr. Bialkin had no recollection of the specific statements made. See also "Citigroup Completes Spin-Off of Travelers P/C with Common Stock Distribution," *Insurance Advocate* 113, no. 32 (August 26, 2002): 24. It is ironic that despite Gramm Leach Bliley becoming law, Citigroup eventually spun off Travelers anyway.

[409] David S. Berry, "Citigroup: Diversified Growth Giant," Keefe, Bruyette, and Woods (KBW), April 10, 1998, Citi Heritage Collection, RG3, Box 26, Accession 2005-00, p.4; Carpenter and Moss, *Preventing Regulatory Capture,*20. Much was made later of Reed and Weil's decision to offer Robert Rubin a position on the executive committee of Citigroup, implying a prior arrangement on the merger. However, there is no evidence to support this contention or that the co-CEOs engaged Rubin in more depth than other major players. The decision was the Fed's to make, not the Treasury's. Of course, this

Weill and Reed lobbying President Clinton, the actual event appears to have been more of a courtesy notification. Given that this conversation was the night before the announcement of the merger, Weill and Reed could not have expected a serious policy discussion on the merits of the merger, which surely would have been worked out in prior discussion with Treasury Secretary Robert Rubin and Director of the National Economic Council, Gene Sperling.[410]

Public Comment on Citigroup Merger

Although the Board did not normally hold public hearings on bank mergers, it felt the Citicorp-Travelers merger generated sufficient interest to justify two days of hearings. The contrast between the official announcements on the hearings and the expectations of the financial community were stark. In its announcement, the Fed made clear this merger was a serious matter that involved a number of activities impermissible to a bank holding company that Citicorp would be required to divest or otherwise conform to current law.[411] The agenda for the public hearings was balanced fairly evenly, with witnesses among leading regulatory officials, members of Congress, financial analysts, banking executives, and community activists.[412]

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was certainly an example of the revolving door in action, which Carpenter and Moss among others define as a mechanism for regulatory cultural capture.

[410] Sandy Weill and Judah S. Kraushaar, *The Real Deal: My Life in Business and Philanthropy*, New York: Warner Business Books, 2006, p.315.

[411] "Announce Public Meeting for June 25, 1998 on the Proposal by Travelers to Acquire Citicorp," Federal Reserve, June 4, 1998, Citi Heritage Collection, RG6, Box 20, Accession 2013-06.

[412] "Agenda: Public Meeting Regarding Citicorp and Travelers," June 25, 1998, Citi Heritage Collection, RG6, Box 20, Accession 2013-06.

Opposition to the Citigroup merger was vocal and powerful, including members of Congress.[413] Representative Maxine Waters, D-CA, known to make extreme statements in support of her positions, went so far as to claim that Citibank was under investigation for laundering money based on a claim that drug lords were clients at Citibank's international private bank. In an obvious delaying tactic, she called on the Federal reserve to halt consideration of the Citigroup merger until all such claims had been investigated by U.S., Swiss, and Mexican authorities.[414] Acorn and other community activists opposed the Citigroup merger on grounds that Citicorp failed to serve the needs of the poor communities where it did business.[415] Still and all, there was also a great deal of support from local groups with whom Citibank had strong local ties and a positive relationship.[416]

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[413] Jo Ann S. Barefoot, "Has CRA become anti-bank activists' new all-purpose tool?" ABA Banking Journal 90, No. 8, August 1998: 23-26.

[414] Maxine Waters, "Statement by Representative Maxine Waters Opposing the Citigroup Merger," April 9, 1998. Citi Heritage Collection, RG3, Box 26, Accession 2005-00.

[415] Patrick Woodall, "Citibank's Poor Lending Record to Minorities Casts Doubts on Merger," ACORN, April 30, 1998, Citi Heritage Collection, RG6, Box 20, Accession 2013-06; Mathew Lee, "ICP Letter in Opposition to Citigroup Merger," April 13, 1998, Citi Heritage Collection, RG3, Box 26, Accession 2005-00. As required by Regulation Y, the Board of Governors reported letters of concern or opposition to Citigroup for comment as desired. Examples of those in opposition to the merger included: Mr. Frank Torres of Consumers Union, Mr. Ralph Nader, Mr. Mathew Lee of Inner City Press/Community on the Move, Mr. Kenneth Guenther of the Independent Bankers Association, Mr. Alex Pitcher of the NAACP, Rep. Joseph P. Kennedy II, Rep. Bill Pascrell, Jr., Rep. Maxine Walters and Rep. Jesse Jackson, Jr., as well as Mr. Michael Lissack. The Federal Reserve Bank reported letters of support from the Long Island Housing Partnership, New Directions Community Services, The Long Island Community Foundation, Latimer Woods Economic Development Association, The County Chamber of Commerce, Greyston Foundation, Community Development Corporation of Long Island, Black Women Enterprises, Wyandanch Home and Property Development Corporation, and the Kings Bay YM-YWCA.

[416] Betsy Cross, "Public Comment on Travelers Application," May 19, 1998, Citi Heritage Collection, RG3, Box 26, Accession 2005-00; Betsy Cross, "Application by

Citicorp-Travelers $115 billion pledge

As background, the purpose of the Community Reinvestment Act of 1977 (12 USC 2901) was to encourage a financial institution to meet the credit needs of all communities in which it operated. Further, as an enforcement mechanism, supervisory agencies were required to take this performance into account when considering approval of expansion or acquisitions by the financial institution. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (PL 101-73) amended the CRA to require public disclosure of certain aspects of each examination results. The grades for meeting community needs that might be assigned ranged from “Outstanding”, “Satisfactory,” “Needs to Improve,” to “Substantial Noncompliance.” Going into the merger, Citibank’s prior Community Reinvestment Rating was “Satisfactory.” This ranking, which was all that was required by the Federal Reserve for approval of a bank merger within a bank holding company, meant that there was little real expectation that its CRA rating would prevent the merger from being approved.[417]

However, in an active effort to buy good will Citicorp and Travelers proactively engaged community reinvestment activists with its $115 billion ten-year Citigroup community pledge, which was a combined lending and investment commitment. Pamela Flaherty, the Citicorp executive responsible for community involvement, highlighted that the pledge was actually quite aggressive, requiring Citigroup to grow mortgage and small

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Travelers Group Inc. to Acquire Citicorp, Inc.,” May 22, 1998, Citi Heritage Collection, RG3, Box 26, Accession 2005-00; James E. Beit, “Federal Reserve Bank of New York Letter to Stacie E. McGinn,” May 19, 1998. Citi Heritage Collection, RG3, Box 26, Accession 2005-00; and James E. Beit, “Federal Reserve Bank of New York,” May 21, 1998. Citi Heritage Collection, RG3, Box 26, Accession 2005-00.

[417] Comptroller of the Currency, “Community Reinvestment Act Performance Evaluation Citibank,” Administrator of National Banks, October 4, 1996, Citi Heritage Collection, RG6, Box 25, 2013-06.

business lending by 8-10% per year in low to moderate income (LMI) communities as well increase community development lending by about 12% per year.[418]

Although not subject to the CRA as an insurance company, Travelers joined in the commitment for its subsidiaries. This was a unique aspect of the Citigroup Community Pledge, made as part of the combined companies' outreach to community activist to soften their opposition to the merger. To its credit Citigroup followed through quite strongly with its commitment. As Flaherty wrote at the end of 1999, in just two years Citigroup raised its LMI community investing and lending by 65%, to almost $14 billion. However, that is not the same as suggesting that this was good public policy. While many of these loans in LMI communities may well have been prudent, the example presented here of the CRA being used to coerce large banks into making significant commitments to subprime mortgages was replicated across the banking world, and likely contributed to the subprime crisis a decade later.[419]

Analysis of the Federal Reserve Board Decision

Not surprisingly, given Greenspan and Mattingly's foreshadowing, the Board concluded that it had the authority to approve the Citicorp-Travelers merger. It acknowledged the scope of the merger, noting that Citicorp, with approximately $331 billion, was at the time the third largest commercial banking organization in the United

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[418] Pamela P. Flaherty, "Comments for the Federal Reserve Public Meeting," Citicorp, June 25, 1998. Citi Heritage Collection, RG6, Box 20, Accession 2013-06; Susan Weeks, "Citibank Pledges $115 Billion to Communities: Includes Insurance for First Time," Citicorp/Travelers, May 4, 1998, Citi Heritage Collection, RG6, Box 20, Accession 2013-06; and Susan Weeks, "Citigroup Pledges $115 Billion to Communities Double Citibank's Domestic Deposits," May 4, 1998, Citi Heritage Collection, RG3, Box 26, Accession 2005-00.

[419] Pamela P. Flaherty, "National Community Commitment Results," Citigroup, December 1999, Citi Heritage Collection, RG5, Box 24, Accession 2005-00.

States and 22nd largest in the world. In its approval the Board acknowledged the principal issue, which was the impermissible activities owned and operated by Travelers, but noted that Travelers committed to ensure its activities conformed to the Glass-Steagall Act and the Boards interpretations thereof.[420]

The merger approved by Federal Reserve Board 6-0 and was expected to close on October 8, 1998. The Board explicitly rejected claims by the IBAA and ICP, among others, that the merger would violate the BHCA and Glass-Steagall. It also rejected CRA-based objections, with a favorable nod to the ten-year, $115B community pledge and an observation that 320 of 425 witnesses were in favor of the merger. Regarding competition, the Board called out the potential advantage to the public (i.e., potential Citigroup customers) of cross selling, and observed that it saw no competitive disadvantage to financial services institutions, which were free to do the same thing.[421]

Responding to criticisms that the merged Citigroup would be "too big to fail," the Board simply noted that this argument had been explicitly considered and rejected by the Supreme Court, which made clear that the market share controlled by a securities firm

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[420] Robert deV. Frierson, "Order Approving Formation of a Bank Holding Company and Notice to Engage in Nonbanking Activity (Travelers and Citicorp)," *Federal Reserve Bulletin*, Legal Developments, 84, no. 11 (November 1998): 985–1016. See also Amy Feldman, "Citi/Travelers Okay: Fed, Justice Going Along with Merger," *New York Daily News*, September 24, 1998, Citi Heritage Collection, RG7, Box 24, Accession 2005-00 for discussion of other approval authorities. For example, approval was required by SEC, Justice, and the European Commission for other regulatory reasons, but only the Federal Reserve was specifically approving the affiliation of the banking, securities, and insurance underwriting functions inherent in the Citicorp-Travelers merger.

[421] Frierson, "Order Approving Formation of a Bank Holding Company," 1015-1016. "Based on the foregoing and all other facts of record, the Board has determined that the applications and notices should be, and hereby are, approved…By order of the Board of Governors, effective September 23, 1988." Note that Governor Roger Ferguson abstained from the vote.

does not determine if it is "principally engaged in securities activities."[422] The Board reaffirmed its position, which had previously been accepted by the Supreme Court, that the relevant standard to determine if a subsidiary was not "principally engaged" was if less than 25% of each subsidiaries' revenue was from underwriting or dealing in bank-ineligible securities. The Traveler's Solomon Smith Barney (SSB) deal met that standard, and the Federal Reserve took the position that it was irrelevant that the combination of Citicorp and SSB formed the largest universal bank in the world by market capitalization.[423]

Overall, the conditions imposed by the Board were in line with expectations and consistent with those requested or recommended by the Citicorp-Travelers application. The major remaining issue was that Citigroup was required to divest its insurance underwriting companies within two years, with three one-year extensions possible. Although Citigroup requested to be able to aggregate its subsidiaries' revenues for purposes of Section 20, the Board required that each securities subsidiary earn less than 25% of its revenue in underwriting and dealing in corporate securities, consistent with prior practice. Regarding ownership of commercial companies as regulated by Section 20, the Board permitted Solomon Smith Barney a two-year grace period to own greater than 5% of a stock for market making, but required that once it bought a company

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[422] *Securities Industry Assn. v. Board of Governors*, 486 U.S. 1059 - Supreme Court 1988. Denied Certiorari (affirming the 2nd Circuit's decision in support of the Federal Reserve Board's interpretation of Section 20.)

[423] Frierson, "Order Approving Formation of a Bank Holding Company," 1006. This is a weak and circular argument. What the Court actually did in the SIA case was accept the Fed's interpretation because of the Chevron doctrine that the regulated agency's interpretation should be deferred to unless there was clear legislative intent. Were the Fed to come to a different conclusion, the court likely would have accepted that as well.

position, it had only 30 days to reduce to its ownership stake to less than 5%. Finally, while cross-marketing was explicitly allowed, the Board required that Citigroup must keep data bases of the different business lines separate, allow customer to opt out of data sharing, and adopt a global privacy policy.[424]

Although the Board's approval of the Citigroup merger was challenged in court, the court found the Board's interpretation of the statutes to be reasonable under the *Chevron* doctrine, and affirmed the approval of the merger.[425]

Flipping the Citicorp Narrative

The most important aspect of the Citicorp-Travelers merger turned out to be reversing Citicorp's position on repealing Glass-Steagall. The removal of Citicorp as an active opponent of the bill would have been significant, but to gain the full lobbying resources of both Citicorp and Travelers in favor of the bill was probably decisive over the course of the next year in getting the law passed.

Recall that prior to the announced Citigroup merger, Citicorp had opposed the Financial Services Modernization Act of 1998 and had helped kill previous attempts in

[424] Frierson, "Order Approving Formation of a Bank Holding Company," 1015-1016; Jaret Seiberg, "Citi-Travelers Gets the Nod," *American Banker*, September 24, 1998, Citi Heritage Collection, RG7, Box 24, Accession 2005-00. This opt out provision was similar to the one eventually inserted into Gramm Leach Bliley.

[425] *Independent Community Bankers v. Bd. of Governors*, 195 F. 3d 28 - Court of Appeals, Dist. of Columbia Circuit, 1999. The Board approved the Citigroup merger on the condition that the new enterprise divest itself of its insurance business within two years, so as to comply with § 4(a)(2) of the BHC Act, 12 U.S.C. § 1843(a)(2) (1994). And it found the acquisition in compliance with §20 of the Glass-Steagall Act, 12 U.S.C. §377 (1994), as none of Citigroup's affiliates would derive more than 25% of gross revenues from bank ineligible securities. The court disagreed with ICBA's contention that the Board's construction of §20, imposing only a *proportional* limit on revenues from ineligible activities, was too loose. While ICBA preferred an interpretation that it intended to prevent the creation of an institution "too big to fail," the Court found the Board's interpretation reasonable.

Congress. However, at a press conference soon after the merger was announced Citicorp Chairman John Reed revealed that Citicorp would now support the legislation albeit with certain modifications. Reed stated that he and Weill, "Would like to see a legal structure similar to (the proposed legislation) without some of the negatives within that."[426]

Citicorp and Travelers began to lobby Congress immediately.[427] This involved a concerted and coordinated campaign that included personal lobbying by top executives, professional lobbying activities, and even grass roots campaigns by Citicorp and Travelers shareholders.[428] Spending by financial services companies, financial trade associations, and individual banks and other financial professionals also increased sharply.[429] *First Call* reported that the Fed approval of the Citigroup merger would increase pressure on Congress from Citicorp and Travelers, as well as other large financial institutions to pass financial services modernization (H.R. 10). It noted that Citicorp and Travelers had been working with the banking and insurance industries to

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[426] Paul Beckett, "Citicorp's Reed Says Mergers Will Benefit Consumers," *Dow Jones News Service*, April 14, 1998, Citi Heritage Collection, RG5, Box 24, Accession 2005-00; "Major Deals Involving (FRB) Hearings," September 1998, Citi Heritage Collection, RG7, Box 22, Accession 2005-00 notes that contemporary bank mergers under consideration by the Federal Reserve contemporaneously with Citigroup included: Norwest/Wells Fargo, Banc One/First Chicago, NationsBank/BankAmerica, and First Union/Corestates.

[427] "Citicorp/Travelers Joint Statement," Reuters, May 13, 1998. Citi Heritage Collection, RG7, Box 24, Accession 2005-00.

[428] "Shareholder Approval," July 22, 1998. Citi Heritage Collection, RG7, Box 22, Accession 2005-00; "Citigroup Needs U.S. Employees' Help on H.R. 10," *Citigroup Countdown*, September 24, 1998, Citi Heritage Collection, RG7, Box 22, Accession 2005-00.

[429] "Financial Services Roundtable Summary | Open Secrets," Accessed September 2, 2017. http://www.opensecrets.org/pacs/lookup2.php?strID=C00193177&cycle=2010.

create compromise positions, which was one reason why the Senate Banking Bill passed in committee (16-2) in the Fall of 1998.[430]

Summing Up the Merger

The approval of the Citicorp-Travelers merger by the Federal Reserve was unprecedented.[431] Yes, the Board provided adequate justification, which was sustained in court. And in many ways, the approval was a logical extension of the Board's previous Section 20 exceptions. However, there is little doubt that in writing Section 20 Congress never envisioned as "incidental" the merger of one of the largest commercial banks in the country with both one of the largest investment banks in the country and a significant insurance underwriter. IBAA's Thomas was also correct that under the original interpretation of Glass-Steagall the courts would not have allowed the merger as an incidental transaction that could be unwound over two to five years. Still, it was apparent that times had changed, as had the prevailing ideological consensus as well as common law precedent.

To address a question posed at the onset of the discussion, there was no evidence that the merger was undertaken by either the companies involved or the Board to force the hand of Congress in any direct way as regards financial modernization per se. All sides recognized that the expected outcome was divestiture of Travelers underwriting unit

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[430] Sam H. Leaman, "Merger Increases Pressure for Financial Bill," *First Call* (HSBC), September 24, 1998, Citi Heritage Collection, RG7, Box 24, Accession 2005-00; "Ex-Treasury Secretary Robert Rubin Joins Company," *Citigroup World* 2, no. 5 (November 1999). As the campaign continued into the next Congress, there was even time to leverage the revolving door of former government officials, as when Robert Rubin went to work for Citigroup as Chair of the executive committee, the same week that Congress and President Clinton reached an accord on the final bill.

[431] Raymond Natter, Interview, February 22, 2017, retained by Timothy Galpin; Leach, "Citicorp, Travelers,"1.

if financial modernization did not pass. But the Federal Reserve approval of the merger clearly said that Glass-Steagall no longer mattered other than as an obstacle to be bypassed! And that indirect statement changed the tone in the Congressional debates, ultimately supporting the repeal of Glass-Steagall.

Historic First: House Votes to Repeal Glass-Steagall

The pending Citicorp-Travelers merger significantly changed the terms of the debate in the House, lending impetus to resolving open issues.[432] The ultimate approval of the Citigroup merger made clear that there were few practical limitations on what affiliations the Federal Reserve would find acceptable beyond those that violated the strict wording of the law. That is, the Citigroup merger emphasized graphically how far out of step from the market the Depression-era Glass Steagall regulatory regime had fallen. It became abundantly clear to Congressional leaders that in order for Congress to have an impact it would need to pass new financial services modernization legislation. As a result, despite the opposition of the Clinton Administration the House passed a historic bill along the lines suggested by the Federal Reserve on 13 May 1998, on a roughly party line vote (214-213). This passed the baton to the Senate to try and pass a repeal of Glass-Steagall before the end of the session.[433]

The House version of H.R. 10 repealed the Glass-Steagall Act restrictions that prevented affiliation among commercial banking, securities, and insurance companies. It did so by permitting the creation of financial holding companies in which banks could

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[432] John J. Roche, "Joint Statement of Citicorp and Travelers Group," Presented at the Committee on the Judiciary, U.S. House of Representatives, Washington, D.C. (June 3, 1998): 3-4.

[433] The party line nature of this vote did not bode well for standing up to a Presidential veto, which was threatened over the holding company-operating subsidiary issue.

affiliate with securities and insurance companies to underwrite or sell securities or insurance, or alternatively allow securities firms or insurance companies to affiliate with banks. The bill assigned an umbrella regulatory oversight role for the financial holding companies to the Federal Reserve, similar to its role in regulating bank holding companies under the BHCA. It did not close the unitary thrift loophole. However, Jim Leach did manage to include for the first time several provisions to specifically support community banks by giving them access to the Federal Home Loan Bank (FHLB) system.

Although House approval of this version of H.R. 10 was a major step forward for repeal, it came without the support of its major industry advocate. The ABA remained opposed, primarily because H.R. 10 as passed failed to close the unitary thrift loophole. Interestingly, the ABA was out of alignment with the largest banks, most especially Citicorp when it changed from opposition to support of repeal in order to validate the merger with Travelers. The reason other large commercial banks were willing to support H.R. 10 was different but equally self-serving. They were simply interested in codifying their regulatory and judicial gains and less concerned than the smaller banks about competition from unitary thrifts associated with retail firms or insurance companies. This defection of the large banks diluted the ABA bargaining position significantly.[434]

Shifting to the Senate

In any event, the ABA had been undermining Glass-Steagall for years, and was more than ready to continue doing so without a bill rather than give on the unitary thrift issue. In testimony before the Senate Banking Committee in June, ABA president Bill

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[434] Nitschke, “Overhaul Squeaks by,” 1301–2.

McConnell's message was that, "A number of fundamental problems in H.R. 10 had to be fixed before the banking industry could support the bill, and we said that tinkering around the edges of the legislation wouldn't help." Given D'Amato's reluctance to act in an election year, the ABA had good reason to believe that it could run out the clock on the 105th Congress.[435]

The banking industry strongly supported D'Amato's 1998 campaign in a competitive race with Representative Charles E. Schumer, D-NY, and former Vice-Presidential nominee Geraldine Ferraro. According to the Center for Responsive Politics, individual contributors associated with the banking industry donated $188,600, and banking political action committees contributed $60,750. This was despite the fact that, as Ken Guenther put it, D'Amato "carried forward a minimalist agenda in terms of legislation and oversight." In the end, in return for its reelection support the banking industry was counting on D'Amato for only one major issue; specifically, to shut down in the Senate the version of H.R. 10 that passed the House in May. The ABA in particular was adamant that no bill pass that did not close the unitary thrift loophole. However, the banking industry was not alone in attempting to sway D'Amato. For example, while the securities and banking industries together contributed a total of $1,900K to D'Amato

[435] William T. McConnell, "Sausage Tastes Better," *ABA Banking Journal* 90, No.8, August 1998:13. Owning a thrift provided a great deal of flexibility to a commercial firm, since they were not subject to any branching or interstate limitations. However, they did have limitations. Thrifts had to be capitalized to at least $2 million, and could make commercial loans only up to 20% of assets. Of that any amount above 10% must be in small business loans. Thrifts also had to meet the "qualified thrift lender test" by holding 65% of its assets in mortgages or mortgage-related investments, as well as certain small business and consumer loans types. Thrifts were also not allowed to lend to any affiliate engaged in activities not permitted to bank holding companies. Finally, unitary thrifts had restrictions on their ability to dividend up monies to its parent are limited by law.

over the six-year election cycle, the insurance industry also donated $700K. In other words, the political contributions tended to offset each other.[436] In an effort to appease the securities and insurance industry that favored the bill, D'Amato promised hearings in the Senate Banking Committee, but implied that there was little chance the Senate would act before the election.[437]

Turf Battles and Federal Regulators

In addition to the unitary thrift issue, another contentious matter to be resolved in the Senate, if possible, was the House decision to favor the holding company structure over the operating subsidiary model. This was more a matter of dispute among federal regulators than among the financial services industries, which viewed this issue primarily as a matter of implementation. On one hand, Federal Reserve Chairman Alan Greenspan testified to the Senate Banking Committee in support of the bank holding company structure.[438] Not surprisingly, he reinforced the points made by Governor Lawrence Meyer to the House Banking Committee on 29 April.[439] On the other hand, Treasury Secretary Robert Rubin left no doubt with the Senate Banking Committee where the Administration stood: "We oppose the bill that very narrowly passed the House, H.R. 10."

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[436] https://www.opensecrets.org/members-of-congress/summary?cid=N00001158

[437] Karen Foerstel, "Politics & Elections: D'Amato: A Streetfighter Prepares for Battle." *CQ Weekly* (June 6, 1998): 1509–12.

[438] Alan Greenspan, "Statement by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, June 17, 1998," *Federal Reserve Bulletin* 84, no. 8 (August 1998): 647–59.

[439] Laurence H. Meyer, "Mergers and Acquisitions in Banking and Other Financial Services," Testimony presented at the Committee on Banking and Financial Services, U. S. House of Representatives, Washington, DC (April 29, 1998): 1-18.

Rubin identified several factors that the Administration opposed. First, and most firmly, he objected that the bill would force financial institutions that include commercial banks to use holding companies and not subsidiaries of banks.[440] Rubin made clear this was unacceptable because, "Banks would gravitate away from the national banking system, and the elected Administration would lose its nexus with the banking system, thereby losing its capacity to affect bank policy." Rubin also reiterated an argument that he and President Clinton made in opposing H.R. 10 in the House. That is, he believed that the holding company structure would start a process of shifting assets from national banks into affiliates within holding companies. This was a familiar argument, but made with the addition of a twist that this process would reduce assets covered by the community reinvestment act.[441]

Rubin offered several other objections to the House version of H.R. 10 in an effort to shape the legislation. For example, Rubin also opposed a feature that Leach had included that made the Federal Home Loan Bank (FHLB) system available to community banks, and allowed them to use agrarian and small business loans as collateral. While this reflected a personal priority of Jim Leach's to help community banks, who felt at a competitive disadvantage to large banks, Rubin argued it did not address underlying problems in the FHLB system, including use of subsidized capital to earn arbitrage profits. Rubin further objected to the expansion of the FHLB beyond its mission of

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[440] Although Leach had clearly sided with the Federal Reserve's interpretation of the holding company verses operating subsidiary issue, he later said he would accept whatever compromise that Greenspan and then Secretary Summers came up with on this matter.

[441] Robert E. Rubin, "Financial Modernization and Its Effects on Our Nation's Economy," Testimony presented at the Senate Banking Committee, Washington, D.C. (June 17, 1998): 4-5.

fostering home ownership. Although Rubin may have felt obligated to raise this issue, there is little indication that Leach faced any real opposition in getting what he wanted on this issue.[442]

Finally, in support of the Comptroller as his subordinate, Rubin argued the bill discriminated against banking interests in favor of the insurance industry by explicitly denying the OCC the judicial deference otherwise accorded a federal regulatory agency when acting on the question of insurance in national banks. That is, functional regulation as written in the House version of H.R. 10 would constrain the ability of the Comptroller to oversee national banks effectively.[443]

As a component of Treasury, the acting Comptroller Julie Williams' testimony reflected the Administration's position. In her testimony, Williams also argued that the implementation of functional regulation went too far. Specifically, she was highlighting that the law as written would imprudently "bar banks from lines of business that are *today*, under current law, permissible for banks to offer." She further noted that, "It will also prevent banks from offering products in the future that the OCC might find to be permissible."[444]

Picking up on this point, Williams teamed with the Ellen Seidman, the Director of the Office of Thrift Supervision, to object to a practical consequence of the way in which

[442] Robert E. Rubin, "Financial Modernization and Its Effects on Our Nation's Economy," Testimony presented at the Senate Banking Committee, Washington, D.C. (June 17, 1998): 1-3.

[443] This is a subset of the functional regulation issue. Insurance companies and state regulators pressed the House to remove the OCC's presumed deference so that insurance commissioners would stand an even chance in court over disputes on insurance in banking.

[444] Julie L. Williams, "HR 10: The Financial Modernization Act of 1998," Testimony before the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate, Washington, D.C. (June 25, 1998): 1-15.

H.R. 10 implemented functional regulation. In a Joint letter to D'Amato as Chairman of the Senate Banking Committee, they specifically called out Section 118 of H.R. 10, which would "limit our agencies' ability to examine, request reports from, and take enforcement actions against functionally regulated insurance and securities subsidiaries and affiliates of bank holding companies (including nonbank subsidiaries of depository institutions)."[445]

Ultimately unable to reach an agreement with the Senate Banking Committee, the Administration invoked the threat of a veto. In a letter to Senate Banking Chairman D'Amato, the White House Chief of Staff said, "I share your perspective that an overhaul of the laws that regulate our nation's financial services industry is long overdue. However, the President will veto the bill if it is passed in this form."[446]

Issues for Democrats

There were two additional issues that President Clinton and Congressional Democrats were concerned about but Leach did not fully address in his bill. The first was financial privacy. This issue was not part of the historical discussion about financial services modernization, but made sense logically given that the cross-selling of information was a stated advantage of allowing banks, securities, and insurance firms to affiliate. Clinton himself was personally concerned about consumer privacy, and had

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[445] Julie L. Williams and Ellen Seidman, "Joint Position of the Acting Comptroller of the Currency and the Director of the Office of Thrift Supervision Administrator of National Banks Concerning H.R. 10," U.S. Department of the Treasury, September 23, 1998.

[446] Erskine B. Bowles, "The Financial Modernization Act of 1998," The White House Chief of Staff Letter to Senator D'Amato (August 7, 1998). William J. Clinton Presidential Library & Museum; C.f. Phil Caplan and Sean Maloney, "Sperling Memorandum to the President Re: Strategy on Financial Modernization," The White House (July 9, 1998). William J. Clinton Presidential Library & Museum on which Clinton indicated that he approved issuing the veto threat as a negotiating tactic.

previously inserted the Administration into debates on medical privacy, so this was a consistent position for him.[447] And for Clinton, wily politician that he was, it had the additional advantage of serving as a rallying point for Congressional Democrats.[448]

Acting Comptroller Williams made the case for including stronger consumer privacy protections. She pointed out that, "New activities and newly permissible affiliations may offer consumers greater convenience and greater choices, but may also give rise to enhanced responsibilities of financial firms to their customers."[449] Thus, even though neither the House nor the Senate acted on privacy during the 105th Congress, the issue was set to rise in prominence in the financial modernization debate in the 106th Congress as a result of Democratic interest.[450]

The other major issue Democrats focused on was community reinvestment. The Community Reinvestment Act was a powerful tool, much favored by Democrats and wielded forcefully by community activists. One National Economic Council analysis for the White House made the impact clear:

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[447] James A. Leach, "Bank Modernization Legislation," Letter from the Chairman, House Committee on Banking and Financial Services to Secretary Rubin, March 26, 1997, Courtesy of the William J. Clinton Presidential Library & Museum. See also PL 104-191, the 1996 Health Insurance Portability and Accountability Act, which was signed by President Clinton as a precursor to the consumer privacy debate that was engendered by electronic records.

[448] Karen Foerstel, "Clinton Presses for Privacy Law," *CQ Weekly* (September 11, 1999): 2122–23.

[449] Julie L. Williams, "Privacy Issues," Testimony before the presented at the Committee on Banking and Financial Services of the U.S. House of Representatives, Washington, D.C. (July 28, 1998): 1-10.

[450] Lori Nitschke, "Financial Services Overhaul Bill Makes Progress in Senate with Nudge from Industry," *CQ Weekly* (September 12, 1998): 2411; James Sivon, Interview, March 22, 2017. Sivon makes the point that the privacy issue actually made it more likely that financial modernization would pass. He said it was an easy issue for most Members to grasp and sell to their constituents. It also brought a lot of Democrats to the bill.

> Community groups have come to recognize how terribly powerful CRA has been as a tool for making credit and financial services available in previously underserved communities. By some counts, $90 billions of CRA-based commitments have been made since this administration took office. HMDA data suggests that the number of mortgages made in low and moderate-income communities is up *22%* and to minorities 33% between 1993 and 1995 (compared with an overall increase in number of mortgages of 10%).[451]

Not surprisingly community activists continued to pressure the Democrats to hold the line on the CRA for whatever new institutions created by financial modernization at a minimum, and if possible to expand the applicability of CRA outside of banking. However, Senator Gramm remained resolutely opposed to expanding CRA beyond banking, and by preference would roll its applicability back within the small banking community.[452]

Gramm's antipathy aside, some sort of compromise was likely on community reinvestment. It was not as if the banking and regulatory community actively opposed the CRA. As the Citicorp-Travelers $115 billion pledge demonstrated, the large banks at had come to see CRA as a cost of doing business, in essence buying political cover for their broader activities. Still, as Laurence Meyer pointed out in remarks to the Consumer Bankers Association, bankers could make a virtue of necessity in terms of meeting CRA requirements. He observed that despite concerns by some policy-makers, "Consolidation

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[451] Ellen Seidman and Paul Diamond, "Memorandum for Gene Sperling: Financial Services Modernization and Community Concerns," The White House (February 24, 1997). Courtesy of the William J. Clinton Presidential Library & Museum.

[452] Andrew Taylor, "Sen. Gramm's Maneuvers Temporarily Derail Financial Services Overhaul," *CQ Weekly* (September 5, 1998): 2344. Gramm had a long history of late term maneuvers to obstruct legislation. In 1992, he killed a popular bill to curb abuses that occurred when limited partnerships were reorganized. Two years later, in 1994, he held up the Riegle-Neal bill on interstate banking and branching over an unrelated dispute with follow Texan and former House Banking Committee Chairman Henry B. Gonzalez, D-TX. And in 1996, he held up passage of a securities bill (PL 104-290) until the final days of the session as he negotiated.

is also creating many advantages and opportunities that can benefit banks and their lower-income communities." This was not just in terms of the resources the larger institutions could bring to bear, but also in creating "substantive working partnerships that make a difference, not just in writing a check and walking away."[453]

Gramm's opposition to CRA provisions appeared to frustrate financial service industry lobbyists, who generally saw the issue as minor in comparison to rationalizing Glass-Steagall framework. Additionally, the proposed merger of Citibank and Travelers Insurance Group lent some urgency to the proceedings as Citibank was now actively supporting the bill. D'Amato made a statement to reporters that while "the committee has made substantial progress in resolving the major issues that have divided the financial community for years…we have not been able to resolve all the differences."[454]

The Senate Banking, Housing, and Urban Development Committee finally cleared H.R. 10 (16-2) on 11 September 1998, bringing the possibility of the repeal of Glass-Steagall during the 105th Congress closer to reality. Even so, at this point Senator Gramm remained opposed to the broader applicability of the CRA under the compromise, and observers expected him to weigh in during deliberations by the full Senate. That is, Gramm allowed the bill to move out of committee, but he planned to kill it procedurally in the full Senate unless he could get additional concessions on to restrict the applicability of the CRA to the new financial services regulatory structure.[455]

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[453] Laurence H. Meyer, "Community Reinvestment in an Era of Bank Consolidation and Deregulation," Remarks presented at the 1998 Community Reinvestment Act Conference of the Consumer Bankers Association, Arlington, VA (May 12, 1998): 1-5.

[454] Taylor, "Sen. Gramm's Maneuvers," 2344.

[455] Taylor, "Sen. Gramm's Maneuvers," 2344.

Industry Positions on the House and Senate Versions of H.R. 10

The securities industry was the easiest of the three financial services to satisfy on repeal legislation. Its trade associations sought a codification of the legal structure allowing securities firms to affiliate with commercial banks, and a functional regulatory structure that preserved SEC oversight of securities markets and broker-dealers via self-regulatory organizations. The securities industry correspondingly supported either the House or Senate version of H.R. 10 because both versions of H.R. 10 would meet its conditions.[456]

Among banking trade associations, support was mixed for the Senate version. The ABA, which was adamantly opposed to the House version, supported the Senate version of H.R. 10 as a result of changes made by the Senate Banking Committee.[457] The ABA persuaded most state banking associations to support the Senate bill as well.[458] The Independent Bankers Association (IBAA) took a position of "not opposed," but had earlier expressed a preference for the holding company structure. America's Community Bankers Association (ACB) wanted to make improvements in the bill in joint conference, particularly on the thrift provisions and to allow for full transferability of grandfathered

[456] Lisa S. Andrews, "Memorandum for Secretary Rubin Re: Industry Positions on H.R. 10," U.S. Department of the Treasury (September 22, 1998): 1-5. William J. Clinton Presidential Library & Museum. SIA's Judge was insightful, because his pessimism on the passage of H.R. 10 proved out.

[457] The changes that persuaded the ABA had to do with the 13 safe harbors in the bill. While ostensibly granting a role to state insurance commissioners, in reality the compromise locked in the OCC's authority over insurance activities in national banks. Support was cautious as some banking strategists viewed the safe harbors as creating too much opportunity for states to enact laws discriminating against banks offering insurance.

[458] Hold-outs included OK, TX, KS, KY, and ND.

powers. Finally, the Bankers Roundtable was brought to reluctant acceptance once the thrift issue was resolved in the Senate Banking Committee.[459]

Meanwhile, the insurance industry was at odds with itself. Even though D'Amato, with the help of Senator Sarbanes, D-MD, was able to pass a marked-up bill out of committee on 11 September 1998, there were several provisions that were different enough from the House version of H.R. 10 that some insurance trade associations pulled their support. For example, the American Insurance Association (AIA), continued to support the legislation, calling it "historic." However, both the National Association of Professional Insurance Agents (NAPIA) and the Independent Insurance Agents of America (IIAA) said they could not support the Senate markup.[460]

The dispute within the insurance industry was primarily about the way in which insurance sales by banks would be regulated by the states. In a letter sent to Senator Carol Moseley-Braun, the IIAA said, "We do not understand how the Senate can claim to be pro states right and favor functional regulation when the effect of this proposed legislation would be massive Congressional pre-emption of state insurance laws." The agents were arguing for a compromise crafted in the House, which stated that the Comptroller would not be granted "unequal deference" for insurance matters in national banks. On the other hand, the Senate version would codify the *Barnett* standard to the detriment of state regulation.[461]

The Alliance of American Insurers (AAI), speaking for the insurance companies, registered concerns with the Senate bill but was willing to accept the changes in order to

[459] Andrews, "Industry Positions on H.R. 10," 1-5.
[460] "To the Floor," *Insurance Advocate* 109, no. 36 (September12, 1998): 36
[461] "No Unanimity," *Insurance Advocate* 109, no. 37 (September 19, 1998): 1.

have the legislation brought to joint conference. The American Insurance Association (AIA) went farther towards acceptance of the changes, and senior vice president David Pratt argued, "The measure will vastly expand opportunities to provide consumers with banking and insurance and securities products, reduce burdensome global competitiveness of the U.S. financial services industry."[462]

As was discussed briefly in the section on functional regulation, bankers and federal bank regulators believed a purely functional regime was untenable. That is, as Meyer pointed out, if the respective functional regulators were only to oversee the insurance, securities, and banking aspects in a bank, no one would be monitoring the overall safety and soundness of the bank as a whole. As we will see, the proposed solution would be to grant that role to the Federal Reserve, but this step began a process of deferring to the regulator's traditional roles under the functional regulation regime.

The bottom line from industry, according to Treasury's assessment, was that, "Whether the banks and the insurance agents can cut a deal remains a central factor in the prognosis for the bill. If an agreement can be reached between these groups, then the changes for enactment dramatically improve."[463]

[462] "No Unanimity," 1; "Opposing Views on Regulation of Banks' Insurance Sales." *Insurance Advocate* 109, no. 36 (September 12, 1998): 3. There was another narrow insurance industry specific issue. The ACLI in particular, driven by its large mutual New York members (Metropolitan and New York Life) wanted a redomestication provision restored that the Senate version had eliminated. This provision would allow mutual insurance companies to move to other states and demutualize, which was a problem for D'Amato who could not appear to be supporting the loss of New York mutual insurance companies to other states.

[463] Andrews, "Industry Positions on H.R. 10," 2.

End Game in the Senate

In the final maneuvers to bring H.R. 10 to the Senate floor, several deals were reached among key industry supporters and across the chambers that were aimed at both passing the law and doing so without a joint conference between the House and Senate.

The most important compromise was that within the broader issue of functional regulation. In lieu of true functional regulation that would have ceded authority over insurance in banking to state insurance commissioners, the banking and insurance industries reached an agreement on technical language that specified 13 “safe harbor” areas in which state insurance regulators could issue rules for both independent insurance agents and insurance sales in banks. For example, one such rule governed how insurance products could be advertised by requiring that banks inform customers when the insurance products being purchased were not federally insured. Insurance agents effectively ended their opposition to the bill with this compromise, which was ultimately preserved largely intact in GLBA.[464]

A further deal was brokered between Senate Banking Chair D’Amato and House Commerce Chair Bliley that allowed the SEC to determine when a product offered by a bank was a security and thus subject to SEC oversight. The compromise further authorized the Federal Reserve to stay such an SEC ruling until the matter could be resolved in court.[465]

Difficulties remained for the bill to achieve passage by the whole Senate, but the various debates in 1998 brought the disparate financial interests close to agreement. Senator Paul S. Sarbanes noted that the Senate version of the bill was “supported, or at

[464] Lori Nitschke, “Financial Services Rewrite Wins Bank-Insurance Deal but Faces Senate Floor Fights,” *CQ Weekly* (October 3, 1998): 2659.

[465] Nitschke, “Financial Services Rewrite,” 2659.

least acquiesced to, by most of the involved groups." Although lobbyists for the financial industries hoped to avoid a conference in the event that H.R. 10 passed the Senate, given the carefully crafted compromises in the House version it was unlikely that House leaders would agree to adopting the Senate bill wholesale.[466]

As the possibility of a bill grew, observers began turning to another major obstacle; namely, that President Clinton might veto the bill unless it incorporated changes demanded by Treasury Secretary Robert E. Rubin. Rubin opposed the way in which H.R. 10 would require the new merged financial entities to be structured as financial holding companies, as Board Chair Greenspan supported, rather than having the choice to organize as banks with operating subsidiaries. Treasury continued to argue that the operating subsidiary model would allow the subsidiaries finances to be mapped to the banks' bottom line, preserving a more appropriate accounting for the finances of the combined entities. The veto threat was tangible because even if both houses could pass the bill with veto proof majorities, the President could arrange the veto for when Congress was not in session and thus unable to act to override.[467]

Rubin himself summarized the state of the legislation in a memo to the White House. He wrote, "The Administration has strongly opposed the bill passed by the House and approved by the Senate Banking Committee. That bill would greatly diminish the role of the elected Administration in financial services policymaking and adversely affect

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[466] Lori Nitschke, "Financial Services Overhaul Bill Makes Progress in Senate with Nudge from Industry," *CQ Weekly* (September 12, 1998): 2411.

[467] Nitschke, "Bank-Insurance Deal," 2659.

the Community Reinvestment Act (CRA)."[468] The former point of course was the Administration's phrase for decrying the lack of an operating subsidiary option in the draft bill. On the latter point, the Administration's position on CRA was strongly backed by community activists who were in turn lobbying Congress heavily.[469]

Given that the House had passed the bill (H.R. 10) in May, many observers thought the 105th Congress was the best chance in decades to repeal Depression-era law separating commercial and investment banking, as well as insurance. However, it became clear by 10 October 1998 that the full Senate would not get the opportunity to consider a bill to repeal Glass-Steagall despite support from federal regulators, increasing support from the insurance and securities industries, as well as portions of the banking community. Although the Senate actually voted 88-11 to take up H.R. 10 on the floor, Senator Gramm made good his threat and managed to slow progress of the bill with parliamentary maneuvers.[470]

There was no doubt of Gramm's intention. He said, "For those who want the bill now, there is one thing you have to do to get this bill. You will have to do something about the expansive CRA provisions." Gramm and his partner Shelby specifically opposed the bill's requirement that community reinvestment provisions be applied to the new financial holding companies. They also opposed the increased penalties to up to $1M per day for non-compliance. Gramm's position was strengthened by President Clinton's

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[468] Robert E. Rubin, "Meeting on Financial Modernization with Citicorp and Travelers Group," Memorandum for Erskine Bowles and Gene Sperling (September 23, 1998):1-7. William J. Clinton Presidential Library & Museum.

[469] Allen J. Fishbein, "Grassroots Opposition to H.R. 10," Memorandum for Sarah Rosen, National Economic Council from the General Counsel, Center for Community Change (September 23, 1998). William J. Clinton Presidential Library & Museum.

[470] Lori Nitschke, "Financial Services Overhaul Appears to Die in Senate, A Victim of Friendly Fire," *CQ Weekly* (October 10, 1998): 2733.

stated intention to veto the bill unless changes demanded by Treasury Secretary Rubin were made. Republican leaders saw no need to force Gramm to retreat given the veto threat. Senate Majority Leader Trent Lott, R-MI killed the bill saying, "We don't want to take a chance on having that bill vetoed." Yet this left open the possibility of legislation in the 106th Congress.[471]

Chapter 3 Conclusion: Assessing the Opening Act

Even though many of the issues surrounding the repeal of Glass-Steagall were left unresolved by the 105th Congress, the associated legislative debates were important because they identified the major policies to be resolved, as well as those that could be deferred, before financial services modernization could be enacted into law. The compromises that were proven to be necessary also made clear to all concerned that the bill would have to be narrowly crafted to focus on repeal if it were to have a genuine chance of success of passing both houses.

In a historic first, the House of Representatives created and took advantage of an open policy window to pass a bill to repeal Glass-Steagall in 1998. However, despite general agreement on the need for the legislation and support for the compromises crafted across both sessions of the 105th Congress, the legislation failed to pass the Senate. The specific issues raised, and in some cases resolved, in the congressional debates set the stage for Glass Steagall to be repealed in the next session of Congress.

One important development, the functional regulation compromise, resulted in narrowing the scope of financial modernization to focus on the repeal of Glass Stegall

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[471] Nitschke, "A Victim of Friendly Fire," 2733. Although the Senate Banking Committee had removed CRA provisions that applied to insurance and securities firms, Gramm and Shelby continued to oppose the application of those provisions to banks in general and to the new financial holding companies in particular.

rather than a broader based reform of the financial system. This was driven by the insurance and securities industries' preference for government oversight through associated self-regulatory organizations, which in turn led to demands for functional regulation. The details were yet to be worked out, but the compromise offered by the insurance agents made clear that the only way to bring them to agreement was if insurance in banking was governed by the same rules as insurance sales outside banking. Similarly, securities firms and the SEC alike would not agree to codify the bankers' intrusions into the traditional securities markets without an agreement that bank securities activities would be subject to the same rules as other broker-dealers. As a result, the final legislation to repeal Glass-Steagall was far more likely to retain current regulatory structures and industry specific rules, and less likely to seek systemic reform of the financial system.

The Depression-era focus of the repeal debate also served to distract the key institutional players from consideration of broader reforms.[472] The case in point was the dispute over whether the law would require a holding company versus operating subsidiaries organizational structure for financial organizations. What is notable is that both Chairman Greenspan and Secretary Rubin framed this issue in terms of which structure best protected the federal safety net, and particularly deposit insurance, from being expanded beyond commercial banks to "too big to fail" financial entities. The irony

[472] Laurence H. Meyer, "Issues and Trends in Bank Regulatory Policy and Financial Modernization Legislation," Remarks presented at the Bank Administration Institute, Finance and Accounting Management Conference, Washington DC, (June 9, 1998):1-8. Meyer was speaking in terms of the deregulatory trend. "Two decades ago we still had Regulation Q, the Glass-Steagall Act was widely viewed as requiring a virtual prohibition of combinations of commercial and investment banking, and interstate banking and branching, let alone combinations of banking and insurance, were barely fantasies even at the state level."

was that in focusing on the New Deal federal safety net, and in preventing the creation of moral hazard, the policy community overlooked key safety and soundness reforms to account for the significant changes in the financial system since the Great Depression.

In any event, the 105th Congress served as a necessary opening act to wring out some churn in the political system as a step towards GLBA. In particular, the regulatory and judicial efforts to undermine Glass-Steagall reached their high-water mark with the approval of the Citicorp-Travelers merger by the Federal Reserve. Thereafter it was clear that Congressional action was necessary to either rebuke the Board or rewrite the law to accommodate the new ideological consensus. Other relatively normal partisan disputes around the budget also served to divide the Congress during the debate.[473] For example, both Congress and the White House were distracted by the turmoil created by the Supreme Court's "common bond" decision, which was eventually resolved by Congress in 1998.[474]

It also became apparent during the legislative debate that the policy process remained fragmented, which provided an opportunity for political entrepreneurs to shape the legislation. Certainly, Ed Yingling of the ABA skillfully opposed H.R. 10 in the House because as written it did not close the unitary thrift loophole. And Secretary Rubin obtained from President Clinton a veto threat to back up his demands to include operating

[473] Carroll J. Doherty, "Legislative Summary: Congress Compiles a Modest Record in a Session Sidetracked by Scandal," *CQ Weekly* (November 14, 1998): 3079–80. As outgoing Speaker Newt Gingrich observed at the close of 1998, "If we don't work together on the big issues, nothing gets done."

[474] Although the banks were technically and legally correct on the "common bond" issue, it was a decision that defied common sense to the average credit union customer. Relative to the power of the banking trade associations, one must also recall that the credit union was an equally powerful industry, with organized and effective trade associations, and generally had the advantage of local (or, grassroots) support.

subsidiaries as well as holding companies in the final bill. Other obvious examples of this were the introduction of consumer financial privacy and community reinvestment as issues by the Clinton White House, primarily as ways to energize the Democratic minority in Congress. Similarly, Senator Gramm skillfully wielded Senate procedure in opposition to H.R. 10 in the dispute with the White House and congressional Democrats on expanding the CRA.

Meanwhile, Representative Jim Leach demonstrated the power available to a congressional committee chairman in shaping legislation. His leadership was manifest in bringing the House together to pass a historic bill of course, but also by including access for community banks to the FHLB in the legislation as a matter of his own personal policy preferences. In another demonstration of his mastery of the issues, Leach was able to resolve the commerce-banking issue on his preferred terms, gaining agreement across the policy community, including Congress, the regulatory agencies, and industry, to forego bringing commerce into banking.[475]

Overall, the efforts of the 105th Congress may have fallen just short in terms of implementing financial services modernization, but the policy disputes, compromises, and failures it raised were important and necessary to make progress on repealing Glass-Steagall in the next Congress. At the least, most of the key factors and issues driving the repeal process and issues had been introduced.

[475] "Legislative Summary: Business and Society (1998)," *CQ Weekly* (November 14, 1998): 3097–3111. In another example of partisan rancor, congressional Republicans were unable to broker an agreement to overhaul bankruptcy laws that was supported by both industry and the Clinton Administration.

Chapter 4: The Final Act for Gramm Leach Bliley

Although the Financial Services Modernization Act of 1999, also known as the Gramm Leach Bliley Act (GLBA), repealed key elements of the Glass-Steagall Act, it did not fundamentally alter the U.S. financial regulatory structure. The political compromises necessary to pass GLBA, notably functional regulation, severely constrained the impact of the law in several important ways. One was that GLBA was far less deregulatory than critics later claimed because it left the oversight of commercial banking, securities, and insurance industries by their respective regulatory agencies effectively unchanged. Moreover, in many ways, GLBA merely formalized the incremental deregulatory measures that had already occurred through the decisions of the judiciary and regulatory agencies. Thus, given the same basic structure and regulatory underpinnings, GLBA had little impact on the behavior of the financial sector in the run up to the 2008 financial crisis. Even less well understood, GLBA was primarily limited to repealing Glass-Steagall to the exclusion of broader reforms necessary to improve the safety and soundness of financial institutions under the new regulatory framework, which was the more significant historical omission.

This chapter examines the final political and legislative steps taken by the 106th Congress to pass GLBA in 1999. To be sure, GLBA was a significant law if considered in terms of its immediate policy impact. It restored U.S. global competitiveness by rationalizing a regulatory framework that had frayed under the pressure of market conditions as well as regulatory and judicial decisions. If considered in the context of policy development over time, GLBA marked the end of an era in banking regulation. That is, it completed a deregulatory trend as key regulators, the courts, and ultimately

Congress responded to market conditions and a change in the prevailing ideological consensus towards neoliberalism by sequentially dismantling parts of the New Deal financial regulatory structure such as interest rate and geographic restrictions on banking. Although GLBA capped this process by repealing the Glass-Steagall Act's separation of commercial banking, insurance, and securities, it ultimately was of limited deregulatory impact since in many ways it merely codified the long term regulatory and judicial repeal of Glass-Steagall. In order to understand why it is necessary to examine the factors that constrained GLBA to focus on the repeal of Glass-Steagall to the exclusion of broader financial modernization.

The policy window for repealing Glass-Steagall opened in 1997-1998 under the press of market events and regulatory actions. As detailed in Chapters 2 and 3, large commercial banks were increasingly able to bypass Glass-Steagall restrictions on selling securities and insurance with the approval of federal banking supervisors. The Securities Exchange Commission (SEC) had long since approved securities broker-dealers to create and money market funds and cash management accounts that competed with banks deposit accounts. And, finally, insurance companies were entering banking via a loophole in the Savings and Loan Holding Company Act of 1967 (SLHCA) that allowed non-banking companies to own unitary thrift holding companies (UTHC). Each of these trends were enabled by supporting judicial decisions made under the *Chevron* doctrine in the wake of Congressional inaction to either protect or modify the Glass-Steagall framework. In that sense, the Federal Reserve's 1998 approval of the Citigroup merger among a commercial bank, securities brokerage, and insurance underwriter merely marked the culmination of two decades of regulatory and judicial rollback of Glass-Steagall.[476]

By 1999, it was increasingly clear to policymakers that Congress needed to act in order to either establish a new regulatory regime, or acknowledge the de facto state of affairs in banking policy. To the credit of Federal Chairman Greenspan and other leading regulators, they too wanted Congress to act in order to improve the competitiveness of the U.S. financial industries relative to foreign universal banks and banking conglomerates. Similarly, banking, securities, and insurance industry leaders were keenly interested in a deal to repeal Glass-Steagall, assuming their respective interests could be protected. Encouraged by compromises in the previous Congress, leaders in both houses expected a fast start on dealing with financial services modernization in the 106th Congress.

Even so, entering the 106th Congress the impediments to repealing Glass-Steagall through legislation were significant. For example, commercial bankers remained secure in their regulatory and judicial victories from the 1990s. As a result, they continued to flex both their lobbying power and the support of the federal banking supervisors (e.g., the Federal Reserve, OCC, and FDIC) to ensure that banks and holding companies

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[476] *Chevron, U.S.A. Inc. v. NRDC, Inc.,* 467 U.S. 837, 842-45, 104 S.Ct. 2778, 2781-83, 81 L.Ed.2d 694 (1984); *Barnett Bank of Marion Cty., NA v. Nelson*, 517 US 25, S.Ct. (1996); *Independent Community Bankers v. Bd. of Governors*, 195 F. 3d 28 - Court of Appeals, Dist. of Columbia Circuit (1999); *ABA Banking Journal* 90, No.1 (January 1998): 8. Although many observers of banking regulation point to the Federal Reserve's approval of the Citicorp-Travelers merger as a forcing function towards Congressional action, the OCC was every bit as aggressive. After having modified its Part 5 regulations in 1997 to permit national banks to engage in previously unallowable activities via subsidiaries, with approval of the OCC, the OCC issued its first approval in December 1998. Specifically, Zions First National Bank was granted permission to underwrite municipal revenue bonds through an operating subsidiary.

codified their ability to sell securities and insurance products. Similarly, the broker-dealer and insurance trade associations leveraged the creation of unitary thrift holding companies to support their demand for functional regulation of financial products, which nominally ensured each of the financial service industries equal access to the markets. And, in something of a bureaucratic turf war, the SEC leadership and state insurance commissioners also supported functional regulation in order to limit the authority of the federal banking regulators over securities and insurance products.

The political landscape remained unsettled entering 1999 as commercial financial interests, regulatory agencies, and policy entrepreneurs in both Congress and the Clinton Administration sought to gain advantage in the legislative process. Ultimately, these disputes diluted whatever energy was available among the policy community to broaden financial modernization beyond the repeal of Glass-Steagall to incorporate safety and soundness measures appropriate for the evolving financial markets. For example, the dispute between Greenspan and Rubin over operating structures and regulatory authorities kept the focus on how best to protect the Depression-era federal deposit insurance system, which deferred consideration of new systemic risks such as “too big to fail” (TBTF) financial institutions. And, perhaps convinced by the new ideological consensus that markets would regulate themselves, the major policy debates between the President and Congressional leaders focused on consumer issues such as community reinvestment, financial privacy, and community banking rather than on the regulation of financial innovations such as derivatives and hedge funds.

What changed to enable the 106th Congress to pass GLBA when previous efforts had failed was a widespread recognition that the policy window was mature. In part this reflected the emergence of new players such as Treasury Secretary Summers, but also that the banking, securities, and insurance industry leaders each came to believe the deal was unlikely to improve. This was after all a political process. The key players understood that Congress needed to pass financial modernization because codification of disparate regulatory and judicial decisions was necessary to provide stability in the financial services industry. Leading financial policymakers and political entrepreneurs then made significant compromises on the remaining major policies issues in order to repeal Glass-Steagall while protecting their interests.

In the end, GLBA codified years of regulatory and judicial decisions into a consistent legislative framework that supported the emerging neoliberal ideological consensus. Those that criticize GLBA for deregulating commercial banking and creating financial institutions that are "too big to fail" misunderstand the point of the law. As explained in Chapter 2, banking mergers were already creating too big to fail conglomerates even before repealing Glass-Steagall.[477] GLBA leveled the playing field in the financial services industry by bringing the insurance and securities industries, along with their regulators, into some parity with the commercial banking community. The resulting financial institutions allowed the U.S. financial services industry to compete effectively in the global financial markets. In that sense, GLBA was an important law.

That said, GLBA did not significantly deregulate the U.S. financial services industries beyond what had already been allowed in the marketplace. Yet neither did it

[477] Cocheo, "One in Five," 7. Large banking mergers concluded in 1998 included NationsBank with Bank of America, which created the first truly coast-to-coast bank national bank, and Chase Manhattan with First Chicago and Chemical Bank, which later merged with JPMorgan.

take effective steps to improve the regulatory structure to encompass the same innovations that were driving global financial markets. This chapter explains why.

Framing the Transition to the 106th Congress

By the end of the 105th Congress both Houses had made significant progress on H.R. 10, a bill to enact financial modernization. Although several key issues remained unresolved entering the 106th Congress, there were two factors framing the debate in 1999 that provided an additional impetus towards compromise. One was the continual convergence of commercial banking, securities, and insurance products in the market, which threatened to render the Glass-Steagall framework moot. The other was a series of changes among influential leaders in the policy community, which created an environment more inclined towards compromise in order to repeal Glass-Steagall.

Convergence in the Financial Services Industries

By 1999, all the major players in the financial services industry – large commercial bankers, securities broker-dealers, and insurance providers – had concluded that U.S. financial firms must converge their product lines in order to be competitive. What was increasingly clear at the start of the 106th Congress was that the financial services industries were going to converge their products and ability to cross-sell regardless of Congressional action. However, industry and trade association leaders preferred to reestablish stability and eliminate uncertainty within the regulatory structure through legislation rather than continual expensive regulatory and court fights. This perspective led them to support repeal of Glass-Steagall and, in general, they were willing to accept some cross-sector compromise in order to achieve it. In other words, market conditions were obliterating the regulatory lines established by the New Deal regulatory framework, and negotiations by industry trade associations with Congress over financial modernization were simply an attempt to establish a new framework on advantageous terms.[478]

ABA president R. Scott Jones noted that bankers were already breaking down Glass Steagall barriers. For example, an ABA Insurance Association study documented that one in five small community banks (under $250 million in assets) were selling disability insurance, and an equal percentage were selling home owners insurance. Similarly, 11% of small community banks, and 16.7% of medium sized banks ($250 million to $1 billion in assets) sell dental insurance. While all of these gains were subject to regulatory review, clearly the bank examiners had concluded that separation among the financial services industries was no longer required.[479]

Similarly, securities broker-dealers and commercial bankers were increasingly offering similar products driven by market demand. While bankers historically had been able to maintain higher profit margins on securities than their nonbank broker-dealer counterparts by focusing on packaged investment products rather than individual stocks and bonds, as well as by paying less, that advantage was eroding. According to the 1999 Consumer Investments Study and the Kehrer-Essex Benchmarking Study, profit margins at banks was slipping due to a shift in consumer demand from annuities to mutual funds, which had lower margins. Oddly, profit per trade was also declining as the banks' securities business matured. This appeared to be due to market competition forcing banks

[478] R. Scott Jones, "Putting Congress in a Half-nelson," *ABA Banking Journal* 91, No. 1 (January 1999): 13.

[479] R. Scott Jones, "A Chance to Break Out of the Mold," *ABA Banking Journal* 91, No. 8 (August 1999): 7; Daniel J. Parks, "Who Wants What," *CQ Weekly* (February 27, 1999): 492.

to increase compensation to their resident broker-dealers to keep them from leaving for nonbank securities firms.[480]

As with the banking and securities, the insurance industry on the whole recognized that that market convergence had fundamentally affected their ability to compete effectively. In fact, the insurance industry was in a losing battle with commercial bankers throughout the 1990s as bankers increasingly turned to fee-based income such as insurance and retirement planning products. As a result, according to one assessment by the *Datamonitor*, insurance companies began adopting two new strategies in the late 1990s. One was demutualization, which removed regulatory restrictions on size and product offerings. And the other was a "growing trend among insurance companies has been the adoption of thrift charters to enter the lucrative field of trust management that is dominated by banks."[481]

Robert Hogue explained that the overall market narrative had shifted to favor full-service companies financial with a global reach. He argued that this reflected the extent to which regulators were already willing to allow corporate mergers in contravention of prior practice and interpretations of the law. For example, Hogue said after the Travelers-Citicorp merger was approved, "Almost everyone now expects Congress to eventually reform the financial services laws." Moreover, he observed that, "Integrated financial

[480] Kenneth Kehrer and Kevin Crowe, "Diminishing Distinctions," *ABA Banking Journal* 91, No.11 (November 1999): 49-50.

[481] "Driving Forces Affecting 1998 Direction of Financial Services Industry Seen Continuing In 1999," *Insurance Advocate* 110, no. 4 (January 23, 1999): 3.

institutions are expected to evolve in the U.S. to a level comparable to everywhere else in the world."[482]

Leadership Changes

In addition to rapidly changing market conditions, the various Congressional and Administration leadership changes in play at the start of the 106th Congress had a significant practical impact on the interplay among the major issues associated with repealing Glass-Steagall. Fortunately for advocates of Glass-Steagall repeal, the right players moved into position to take advantage of the open policy window.

Not least were changes in Congress itself. The congressional scene changed in meaningful ways after the elections of 1998, both in terms of positional changes as well as changes in the priority accorded to repeal of Glass-Steagall. For example, although the Republicans still controlled both houses, Speaker of the House Gingrich's, R-GA, resignation was expected to enhance collaboration among the parties given his adversarial style. Similarly, while Senate Majority Leader Trent Lott, R-MI retained his position, he announced in January that he placed financial modernization among the top ten priorities for the session.[483]

Although their perspectives were very different, both the House and Senate Banking Committee chairmen in the 106th Congress also were motivated to enact legislation to repeal Glass-Steagall. On the House side, Jim Leach was facing the end of his tenure. By House rules, Leach was required to step down as chair after the 106th Congress. Having made financial services modernization the top priority during his

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[482] Robert D. Hogue, "Financial Perspectives and Overviews," *Insurance Advocate* 110, no. 8 (February 20, 1999): 34.

[483] Daniel J. Parks, "'Push Is On' for Financial Services Overhaul, but a Big Obstacle Remains," *CQ Weekly* (January 30, 1999): 263–64.

tenure as chairman, Leach was expected to put on a strong push to complete the repeal effort in 1999.[484]

On the Senate side, as previously mentioned, Senator D'Amato had lost his reelection bid, and Senator Phil Gramm, R-TX now replaced him as Senate Banking Committee Chairman. Gramm stated categorically that he considered financial modernization legislation to be important. Yet he was also one of the most serious impediments to bringing H.R. 10 to the Senate floor in the 105th Congress over his opposition to the Administration expanding community reinvestment requirements. Leading Democrats knew that they would need some way to accommodate Gramm's views. In an internal memo, Treasury officials considered the impact of changes in Congressional leadership for its legislative strategy. Despite Gramm's strong stance on CRA, the Treasury staff believed he was at least open to a compromise on the dispute between Greenspan and Rubin over placing nonbank activities in bank operating subsidiaries. Treasury analysts also considered Gramm to be potentially sympathetic to Rubin's opposition to Leach's plan to expand Federal Home Loan Bank (FHLB) guarantees to community bankers.[485]

As for the Administration, Treasury Secretary Rubin announced he would step down effective July 4, 1999. At first, there was little to no change expected in Administration's economic and financial policy. Not only would Federal Reserve Chair Alan Greenspan be continuing in office, but Rubin would be replaced by Deputy

[484] Jones, "Putting Congress in a Half-nelson,"13.
[485] Richard S. Carnell and Gregory A. Baer, "Rethinking Financial Modernization Legislation," Department of the Treasury (November 14, 1998): 1-11. William J. Clinton Presidential Library & Museum.

Secretary Larry Summers, who had indicated he agreed with Rubin's prior policies.[486] However, Rubin's departure ultimately became a key enabler of the law. Recall from Chapter 3 that he and Greenspan were at an impasse over holding company versus operating subsidiary issue. While Rubin had wrangled a threatened Presidential veto to support his position, neither Summers nor Clinton were as invested in the outcome. In the end, Greenspan and Summers were able to negotiate a key compromise on this issue that brought GLBA across the finish line.[487]

Hence, entering the 106th Congress there was some room for optimism, even though significant obstacles remained. As Jim Leach stated, "There is as close to general consensus as there has ever been, and there is probably ever likely to be, on financial modernization." Leach then kicked off the process by introducing a financial services reform bill (H.R. 10) to the House Banking and Financial Services Committee on 6 January 1999.[488]

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[486] Lori Nitschke, "Banking and Finance: Senate Likely to Confirm Summers," *CQ Weekly* (June 26, 1999): 1546. Interestingly, while the Finance Committee had sole jurisdiction in committee over Summer's confirmation, the Chair of the Senate Banking, Housing, and Urban Affairs Committee, Senator Gramm, R-TX also held hearings on Summer's nomination. In the end, those hearings were uncontroversial and Gramm expressed his support of Summers, who was confirmed 97-2 on July 1, 1999.

[487] Daniel J. Parks, "Finance: Summers Faces Tough Questions on Taxes and Monetary Policy, But Confirmation Appears Secure," *CQ Weekly* (June 19, 1999): 1459; "Bob Rubin's Community Outreach," *Institutional Investor* 33, no. 11 (November 1999): 14. In a classic case of the revolving door, Robert Rubin later joined the executive leadership of Citigroup. Named chairman of the executive committee and member of the office of the chairman at Citigroup, Rubin's role was defined generally, but seemed tailor made to provide him a venue for his forays into public policy. While his official role was to advise on corporate strategy, he appeared to inherit an unofficial role to mediate between Reed and Weill.

[488] Parks, "Push Is On"263–64. Certainly, skepticism was present outside of Congress. Robert E. Litan, director of economic studies at the Brookings Institution, said of the House and Senate versions of H.R. 10 and the issues that divided them, "I just don't know if there's a compromise there."

The Remaining Major Policy Issues

There was virtual unanimity among the financial industry leaders and policy community on the core issue. They all agreed the time had come to repeal the archaic laws separating banking, securities, and insurance businesses. The financial services industry trade associations and federal regulators alike touted the advantages to consumers as well as the U.S. economy.[489] Industry leaders and policymakers emphasized that reforming the Depression-era regulatory structure would eliminate the competitive disadvantage U.S banks faced internationally.[490] While some saw this as a way to expand competition in the market place by creating "one-stop shopping" opportunities to benefit consumers, still others believed that repeal would lead to innovation of products and efficiencies in the financial markets. Finally, the policy community as a whole had come to share Chairman Greenspan's conclusion that, "Only Congress has the ability to fashion rules that are comprehensive and equitable to all participants and that guard the public interest."[491]

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[489] John D. Hawke Jr., "Comptroller Warns That H.R. 10 Would Undermine Safety of National Banking System," Testimony before the Committee on Banking and Financial Services of the U.S. House of Representatives, Washington, D.C. (February 12, 1999):1-9. See also John D. Hawke Jr., "Comptroller Warns That Senate Proposal Would Compromise Safety and Soundness of National Banking System," Testimony before the Committee on Banking, Housing, and Urban Affairs of the United States Senate, Washington, D.C. (February 24, 1999): 1-25. Hawke did include some caveats regarding operating subsidiaries, privacy, and balance between the OCC and state insurance commissioners about insurance sales in banks. These will be discussed below.

[490] Laurence H. Meyer, "Mergers and Acquisitions in Banking and Other Financial Services," Testimony presented at the Committee on Banking and Financial Services, U. S. House of Representatives, Washington, DC (April 29, 1998): 1-18; Daniel J. Parks, "Where Gramm Draws the Line," *CQ Weekly* (April 24, 1999): 944.

[491] Alan Greenspan, "Federal Reserve Views on Legislation to Modernize the U.S. Financial System," Testimony presented at the Committee on Banking and Financial Services, House of Representatives, Washington DC (February 11, 1999): 1-12; Alan Greenspan, "Need for Financial Modernization," Testimony presented at the

At the same time, two major distractions had been resolved during the 105th Congress, or were at least far enough along that they could be discounted in the new Congress. In one case, Congress had to deal with the issue created when the Supreme Court sided with bankers to limit credit union membership to groups with a "common bond."[492] The Republican leadership in the 105th Congress attempted to placate the credit union trade associations and reverse the Supreme Court by including a revision to the Federal Credit Union Act as part of H.R. 10. When that bill failed, the "common bond" issue was separated from Glass-Steagall repeal and resolved in the Credit Union Membership Access Act (CUMAA), signed by President Clinton on 7 August 1998.[493]

And in the other case, the impeachment ordeal for President Clinton was nearly complete. This ugly and drawn out affair left both Congress and the Administration ready to focus on policy. As the *ABA Banking Journal* commented, "Congress has everything to gain from putting the memory of the impeachment process behind it as quickly as possible and moving on to legislating."[494]

Yet even with much of the way now clear for financial services reform, there were several defining issues that remained unresolved at the onset of the 106th Congress. This section lays out the status as Congress embarked on repeal in 1999. Several of the

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Committee on Banking, Housing and Urban Affairs United States Senate, Washington, DC (February 23, 1999): 1-7. Given the expansive Section 20 interpretations that the Fed had been approving, including the Citigroup merger, there is a certain irony in Greenspan's statement that, "Without Congressional action, changes will occur through exploitation of loopholes and marginal interpretations of the law that courts feel obliged to sanction."

[492] *National Credit Union Admin. v. First Nat. Bank & Trust Co.*, 522 US 479 - Supreme Court 1998.

[493] PL 105-219. https://www.congress.gov/bill/105th-congress/house-bill/1151

[494] Dan Carney, "Impeachment Watch: With the Clinton Case Closed, Whom Might Congress Judge Next?" *CQ Weekly* (February 20, 1999): 424; R. Scott Jones, "Looking for Life After Impeachment," *ABA Banking Journal* 91, No.3 (March 1999): 13.

open issues were driven by the financial services industry trade associations and their regulatory community, including functional regulation, allowable post-repeal bank operating structures, unitary thrifts, and mixing commerce and banking. Other issues, notably those related to consumer protection and community banking, were injected into the political process by policy entrepreneurs. The most important of these were community reinvestment, privacy, and expanded access to the FHLB system for community banks.

Several of these issues had no clear path forward. For example, the Clinton Administration had prevented the enactment of H.R. 10 in the 105th Congress by threatening to veto any legislation that did not accommodate the Democrats' policy preferences on holding company operating structures and community reinvestment. Indeed Wayne Abernathy, former staff director at the Senate Banking Committee, observed that if it were not for these two veto threats, GLBA would have been named "D'Amato Leach Bliley."[495]

Functional Regulation

The compromises necessary to pass GLBA inherently limited the scope of reform and prevented a fundamental restructuring of the financial system. In many ways, the legislative fight over financial services modernization was really about how the financial markets and regulatory oversight would be restructured to accommodate the affiliation of commercial banking, securities, and insurance. Given that trade associations for both the

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[495] Wayne Abernathy, Interview, January 23, 2018, retained by Timothy Galpin. Mr. Abernathy added community reinvestment to this short list. His point was that it was the veto threat against the holding company issue that got the Senate to pull the bill instead of resolving Senator Gramm's CRA issue. Otherwise, he observed, the majority of GLBA's final features were already contained in the 1998 financial modernization bill.

large commercial bankers and the insurance industry had each demonstrated that they had the lobbying wherewithal to prevent enactment of legislation that did not address their needs, a policy compromise had to be crafted that both sides could accept. Similarly, each regulatory agency had its own support within Congress, which meant that they had the influence necessary to prevent any repeal of Glass-Steagall that did not preserve their authorities. As a result, the debate centered on proposals for functional regulation that maintained the jurisdictions of the federal bank supervisors, the SEC, and state banking and insurance commissioners. These constraints meant that GLBA as passed would be significantly less deregulatory than often credited simply because the underlying regulatory structure was retained.[496]

Although the basic functional regulation compromise had been reached among the financial services industries and with both Congress and the regulatory state during the debates of the 105th Congress, the details had never been reconciled between the House and Senate versions of H.R. 10. Generally, the so-called functional regulation compromise allowed bank supervisors to oversee banks while nominally ceding to the SEC authority over bank securities transactions as well as requiring bank insurance sales to be subject to the authority of state insurance commissioners. However, the start of the new Congress presented an opportunity for industry leaders and key policymakers to reengage to position themselves for best advantage in the final law. As a result, a number of key issues remained to be resolved.

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[496] The so-called functional regulation compromise allowed bank supervisors to oversee banks while nominally ceding to the SEC authority over bank securities transactions as well as requiring bank insurance sales to be subject to the authority of state insurance commissioners.

One dispute was between the Comptroller and the National Association of Insurance Commissioners (NAIC) regarding the oversight of insurance sales in national banks. Successive Comptrollers, backed by the federal courts, claimed authority over insurance sales in national banks. Yet the insurance commissioners refused to cede authority for insurance regulation to the federal government, and the insurance agents wanted a level playing field on which insurance sales in banks were subject to the same rules as independent agents. At the end of the previous session, the Senate version of H.R. 10 preserved OCC primacy over state law regarding national banks but established 13 specific authorities, sometimes called "safe harbors," for state insurance commissioners over insurance sales in banks. This version of the law became the starting point of negotiations on functional regulation in 1999.[497]

John D. Hawke, the newly appointed Comptroller of the Currency, objected to compromise provisions in H.R. 10 that diluted the authority of the Comptroller over national banks as regards insurance. In other words, he objected that explicitly calling out authorities for state insurance commissioners over insurance in banking created "a confusing array of carve outs that advantage insurance companies over the ability of banks to sell insurance." Hawke remained concerned that state insurance commissioners would establish rules that placed national banks selling insurance at a disadvantage to insurance agents. However, Congressional leaders continued to stand by the safe harbor approach as a reasonable compromise between federal and state regulatory authority.[498]

Beyond insurance in banking, the financial services industries were also internally divided among themselves on how to resolve the issue of functional regulation of

[497] Parks, "Who Wants What," 492.
[498] John D. Hawke Jr., "Comptroller Warns That H.R. 10," 8.

securities in banking. Banks in general favored federal oversight of any new securities activities, and at the federal level preferred to be regulated by banking regulators rather than by other agencies such as the SEC. As Abernathy explained, a bank traded on public confidence that allowed long-term investments that were many times the deposits on hand. Public enforcement actions, as were handed down by the SEC, undermined public confidence in the institution so chastised. Hence banks preferred not to be exposed to SEC oversight and potentially damaging public enforcement actions.[499]

The securities industry opposed the approach taken by the large commercial bankers. The Securities Industry Association (SIA), representing securities firms and investment bankers, argued that the SEC should regulate the underwriting and sales of securities whether by investment banks, commercial banks, or insurance firms. The SIA further advocated authorization for securities firms to own banks in an affiliate holding company structure. The underlying premise for the securities industry was that, with profits per trade declining in the securities business, and competition for investment banking business from law firms and corporate in-house specialists, the broker dealers needed access to the profit potential offered by participation in commercial banking in order to level the playing field.[500]

Among federal regulators, the SEC's Levitt argued for complete regulatory authority over securities transactions while federal bank regulators (i.e., the Federal Reserve, OCC, OTS, and FDIC) argued that federal oversight of bank securities activities should at minimum to be shared between banking regulators and the SEC. All federal

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[499] Abernathy, Interview, January 23, 2018.

[500] Robert D. Hogue, "Financial Services Modernization," *Insurance Advocate* 110, no. 20 (May 15, 1999): 38.

banking regulators agreed that the SEC should not be given authority over traditional banking activities, including existing securities activities by commercial banks.[501] However, SEC Chairman Levitt was adamant and outspoken that the inverse also be enforced. This led him to argue against the final draft of H.R. 10 in the 105th Congress. "By repealing provisions of the Glass-Steagall Act without removing the bank exemptions from federal securities laws, this draft bill would create a dangerously bifurcated system of regulation," Levitt claimed. As a result, "A significant portion of securities activities would take place outside the protections of the securities laws."[502]

SEC Chief Counsel Harvey Goldschmid raised an additional important issue about the fundamental difference between banking and securities regulation. "Banking regulation properly focuses on preserving the safety and soundness of banking institutions and their deposits, and preventing the failure of banks," he noted. But securities regulation is about enforcement and transparency. Goldschmid continued, "Because market integrity and investor protection are not principal concerns of banking regulation, the Commission believes that banking regulation is not an adequate substitute for securities regulation."[503]

Similar to the insurance industry, the securities industry had internal divisions regarding federal and state regulation of securities activities by banks. State securities regulators wanted shared oversight of all securities transactions, including those by

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501 Abernathy, Interview, January 23, 2018.

502 Arthur Levitt, "Concerning Financial Modernization Legislation," Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C. (February 24, 1999).

503 Harvey J. Goldschmid, "Concerning H.R. 10, The Financial Services Act if 1999, presented at the Committee on Banking and Financial Services, U.S. House of Representatives, Washington, D.C. (February 12, 1999).

banks. In contrast, the SEC wanted sole oversight of bank securities operations with no involvement by federal bank or state securities regulator.[504] Thomas E. Geyer, speaking for the North American Securities Administrators Association Inc., laid out the concern of state securities regulators that H.R. 10, by not protecting the role of state regulators with sufficient force, could harm consumers by permitting bank staff to sell securities without state required training and registration. And as a general rule, consumer groups preferred state regulation to federal regulation as more responsive to customer needs.[505]

Operating Subsidiaries versus Holding Companies

Instead of considering new safety and soundness measures, the debate over financial modernization continued to focus on a disagreement between Federal Reserve Chairman Alan Greenspan and Treasury Secretary Robert E. Rubin over the organizational structure under which banking, securities, and insurance would be allowed to merge. The argument between the two positions coming into the 106th Congress was public and high profile. Although often attributed to a turf battle (i.e., the Treasury's OCC would regulate bank operating subsidiaries, whereas the Fed would regulate holding companies), it was also true that these views reflected genuine differences in policy views.[506]

Federal Reserve Chairman Alan Greenspan argued that nonbanking financial activities should be conducted from holding companies and separate from the associated bank in order to preserve safety and sounds of the banking system. In his view, the holding company construct was superior if for no other reason than it did not place

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[504] Daniel J. Parks, "Fuzzy Battle Lines Complicate Effort to Overhaul Financial Services," *CQ Weekly* (February 27, 1999): 491–93.

[505] Parks, "Who Wants What,"492.

[506] Parks, "Fuzzy Battle Lines," 491–93.

federal deposit insurance at risk, whereas the operating subsidiary construct might do so if banks were held liable for their subsidiaries' financial failures. That is, in terms of banking reform, he continued to equate the safety and soundness of commercial banks largely with preserving deposit insurance from moral hazard, which was the original premise of the Glass-Steagall separations of banking from securities and insurance. As Greenspan put it, "The requirement that the new powers be conducted through holding company affiliates minimizes the expansion of the use of the subsidies arising from a safety net backed by the U.S. taxpayer and serves to promote the safety and soundness and stability of our banking and financial system."[507]

Rubin remained adamant that banks be allowed to bring insurance and securities activities under the bank ownership as operating subsidiaries, in a structure that would be regulated by the Treasury's Office of the Comptroller of the Currency. He was concerned that the holding company structure recommended by Greenspan, which would be regulated by the Federal Reserve, would have the practical effect of precluding the officials of the elected administration (i.e., the Treasury) from having oversight over banking policy. Rubin also argued the holding company affiliate structure could be too complex and costly for smaller banks. Regardless, under Rubin the Clinton Administration was committed to the view that securities and insurance could be safely

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[507] Greenspan, "Federal Reserve Views on Legislation to Modernize the U.S. Financial System,"1-12; Laurence H. Meyer, "Financial Modernization: The Issues," Remarks presented at the 1999 F. Hodge O'Neal Corporate and Securities Law Symposium, Washington University School of Law, St. Louis. MO (March 12, 1999): 1-7. Meyer added the additional thought that, "The primary window through which the Fed maintains contact with, and oversight of, the largest and most complex banking organizations is as supervisor of bank holding companies…the latter role, I might add, would decline significantly if the op sub, the banking subsidiary, approach were adopted."

operated as subsidiaries of the banks. And he explicitly wanted to retain the OCC's oversight authority under the new law by preserving the option to use that operating structure.[508]

Other leading federal regulators tended to support Rubin, at least to the extent of preserving flexibility. The Comptroller of the Currency objected to the fact that H.R. 10 as written did not allow banks to choose the most efficient way to organize their business. That is, consistent with safety and soundness, Hawke believed a financial institution might choose either a holding company or operating subsidiary structure depending on the circumstances. FDIC Chair Donna Tanoue agreed. She testified that, "From a safety-and-soundness perspective, both the bank operating subsidiary and the holding company affiliate structures can provide adequate protection to the insured depository institution from the direct and indirect effects of losses in nonbank subsidiaries or affiliates."[509]

Ironically, both the Federal Reserve and Treasury argued that each other's position would undermine the federal safety net. Congressional leaders were inclined to agree with Greenspan's position, but were not dogmatic about it. Both Leach and Gramm

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[508] Carnell and Baer, "Rethinking Financial Modernization Legislation," 1-11; Parks, "Push Is On," 263–64. The 1998 Asian crisis had been used by some to argue against operating subsidiaries on the grounds that a bank subsidiary structure would leave US banks vulnerable to a similar failure mechanism. Carnell and Baer argued this criticism failed to consider safeguards in the Treasury operating subsidiary proposal, which included capital reduction requirements, consolidated financial reporting, and protections offered by Federal Reserve Act 23A restrictions.

[509] Hawke, "Comptroller Warns That H.R. 10," 4; Donna Tanoue, "Testimony of Donna Tanoue, Chairman Federal Deposit Insurance Corporation on H.R. 10, Financial Services Act of 1999," Statement presented at the Committee on Banking and Financial Services United States House of Representatives, Washington, D.C. (February 12, 1999): 1-3. See also Donna Tanoue, "Testimony of Donna Tanoue Chairman Federal Deposit Insurance Corporation on Financial Services Modernization Act of 1999," Statement presented at the Committee on Banking, Housing, and Urban Affairs United States Senate, Washington, D.C. (February 24, 1999):1-5.

expressed a willingness to go along with any reasonable compromise among the parties. In any event, this dispute between the positions taken by the Federal Reserve and the Treasury Department remained unresolved entering the 106th Congress.

Unitary Thrift Holding Company

As discussed in Chapter 3, in the late 1990s the large insurance companies began exploiting the unitary thrift holding company (UTHC) loophole to apply pressure on the large commercial banks to accept Glass-Steagall repeal legislation on terms acceptable to insurance trade association leaders. It became clear during the debates of the 105th Congress that the UTHC issue was effective leverage for the insurance company negotiators. That is, since acquiring a unitary thrift holding company was a legitimate way for insurance companies to enter banking while side-stepping the Glass-Steagall framework, this strategy tilted the playing field to their advantage. For example, unlike commercial banks, UTHCs had no restrictions on affiliations among banking, securities, and insurance. Furthermore, the Office of Thrift Supervision (OTS) imposed no capital reserve requirements on UTHCs, whereas the banking examiners imposed significant reserve requirements on commercial bank holding companies. The bottom line was that the UTHC issue at least allowed the insurers to negotiate with the commercial bankers on equal terms over repealing Glass-Steagall.[510]

For their part, bankers believed they had to take the UTHC issue off the table or risk losing their competitive advantage to large diversified insurance companies. For example, insurance companies acquiring UTHCs brought with them established brands, large sales forces, and wide distribution networks that posed a real threat to the trust and

[510] Joseph Asher, "The Great Financial Crossover," *ABA Banking Journal* 91, No.1 (January 1999): 38-42.

private banking departments that were crucial to the success of midsize and regional banks.[511] As incoming ABA president R. Scott Jones said, “In the time that Congress was debating what a bank should be, State Farm became one (by gaining approval to become a unitary thrift holding company). Now State Farm will be able to offer a full range of banking services and market them by direct mail and eventually through State Farm's 16,000 agents nationwide.” In effect, insurance companies could bank without restrictions, but reverse was not true. From Jones’ perspective, this highlighted the need for Congress to act to modernize banking.[512]

Although leading bankers concluded that the House version of H.R. 10 from 1998 unfairly advantaged the insurance and securities industries at the expense of banks, both Congress and the regulatory community was generally neutral on the question of unitary thrift holding companies. For example, OTS Director Ellen Seidman believed that opposition to UTHCs was misplaced. She pointed out that the debate was overly focused on the ownership issue and failed to consider the matter of governance, which in fact required thrifts to operate with significant restrictions relative to banks. As a result, Seidman opposed the “provisions of H.R. 10 that would restrict existing and future, lawful unitary thrift holding company activities.”[513]

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[511] Asher, “The Great Financial Crossover,” 38-42. Insurance companies were also using unitary thrifts to deliberately target a core business of the banks: trust management. Other businesses had successfully demonstrated that thrifts could be used to establish trust management departments, including Merrill Lynch, Morgan Stanley Dean Witter, the Fidelity and Legg Mason mutual fund groups, and the Advest brokerage group. However, the business of trust management was an even better fit with the product lines of insurance companies and brokerages than it was for these other financial services and retail companies.

[512] Jones, “Putting Congress in a Half-nelson,”13.

[513] Ellen Seidman, “Financial Modernization and H.R. 10,” Testimony before the Committee on Banking and Financial Services of the United States House of

The upshot of the UTHC dispute was that it served as an impediment to repealing Glass-Steagall because bankers would not agree to financial modernization without repeal of the loophole. Indeed, the bankers and their trade associations had demonstrated in the 105th Congress that they were both ready and able to muster sufficient lobbying and grassroots efforts to prevent any bill from passing that did not also close the unitary thrift loophole. The large insurers were willing to let it go, but not until extracting concessions from the banking partisans. It remained an issue for the 106th Congress, but one that most observers expected to be resolved.

Banking and Commerce

The final major policy debate associated with repealing Glass-Steagall entering the 106th Congress was mixing banking and commerce retail business. This issue was related to the unitary thrift issue, in that one way of allowing such mixing was by a commercial company acquiring a unitary thrift. However, mixing banking and commerce raised a broader set of concerns beyond the UTHC disputes. As with the separation of commercial banking and investment banking, the U.S. was an outlier among modern industrial nations in separating commercial firms and banking. Many economists argued

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Representatives, Washington, D.C. (February 12, 1999): 1-10. See also Ellen Seidman, "Financial Modernization Legislation," Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C. (February 24, 1999): 1-19 for a similar view. The restrictions on thrifts included: a prohibition from making loans for activities not permitted to bank holding companies; have restrictions on commercial loans to 10% of portfolio, and 65% must be in mortgages or small business loans; have OTS dividend limitations that restrict how much a thrift can transfer to its parent company; and have "anti-tying" restrictions prevent loans on favorable terms to affiliates.

that it was logical to remove this restriction in conjunction with repealing the separation of banking, insurance, and securities.[514]

On the other hand, the FDIC and OTS were both supportive of allowing commercial firms and banking to mix within reasonable restrictions. Tanoue was explicit, "The FDIC supports a cautious easing of the restrictions on the mixing of banking and commerce, consistent with safety-and-soundness considerations."[515] Seidman was equally supportive, based on experience in the S&L crisis. She noted commercial owners sometimes acted to stabilize thrifts. For example, she testified, "We are aware of over $3 billion of capital infused in 79 failed thrifts by commercial firms during the late 1980s."[516]

Advocates of mixing banking and commerce were placed at a disadvantage by contemporary economic events. As discussed in Chapter 3, many observers considered the Asian model of mixing bank ownership and large industrial concerns to have been a primary cause of the "Asian Contagion." For example, Greenspan testified that after consideration of the Asian financial crisis in 1998, the Federal Reserve urged caution on mixing commerce and banking. Instead, Greenspan noted that, "It seems to us wise to move first toward the integration of banking, insurance, and securities as envisioned in

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[514] Bernard Shull, "The Separation of Banking and Commerce in the United States: An Examination of Principal Issues," Office of the Comptroller of the Currency (April 1999): 1-92. OCC trades the potential advantages such as reduced cost of capital, market efficiencies, and reduced transaction costs against the cultural and political issues such as: "the dominance of large banking organizations over large commercial firms; the murky sources of control, including political connections; the symbiosis between large banks and the government; the vulnerability of small business; the appealing "security" of a social system characterized by large and powerful organizations; and the resistance of the system to change."

[515] Tanoue, "Financial Services Act of 1999,"1-3.

[516] Seidman, "Financial Modernization and H.R. 10,"1-10.

H.R. 10 and employ the lessons we learn from that important step before we consider whether and under what conditions it would be desirable to move to the second stage of the full integration of commerce and banking."[517]

Hence, despite some earlier efforts to incorporate mixing banking and commerce, Congressional leaders appeared ready to write off the mixing of commercial activity and banking as a distraction to getting financial modernization legislation passed. For example, Senator Gramm, a free market-oriented economist by training, had supported mixing banking and commercial retail activities in the 105th Congress, but did include it in the current Senate bill.[518] Leach was personally opposed to allowing banks to engage in commercial nonbanking enterprises. He and others feared that banks could deny credit to commercial competitors, that it would lead to too much concentration of wealth, and that the safety and stability of the banking system could be threatened by commercial failures.[519]

In one sense, the decision not to include a repeal of the Glass-Steagall rules that prohibited the mixing of commerce and banking was in the evolutionary tradition Congress had followed to chip away at the New Deal banking rules. Interest rate constraints and geographic restraints had fallen sequentially, and now it appeared that

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[517] Greenspan, "Federal Reserve Views on Legislation to Modernize the U.S. Financial System," 1-12.

[518] Carnell and Baer, "Rethinking Financial Modernization Legislation," 3-4. In the 105th Congress, H.R. 10 contained a similar 15% basket. One thing that changed the general acceptance of this provision was the Asian financial crisis, which appeared to have been exacerbated if not caused by links between commercial firms and the financial sector.

[519] James A. Leach, E-mail to Timothy J. Galpin, November 20, 2017; Parks, "Fuzzy Battle Lines," 491–93. The IBAA position was that smaller banks would be unable to take advantage of the provisions, putting them at a competitive disadvantage to large banks that could afford to buy large businesses and cross-market commercial and financial products.

Congress preferred to concentrate on the separation of banking from insurance and securities before taking on commerce and banking.

Policy Entrepreneurship and Financial Modernization Legislation

Major policy issues directly related to repealing Glass-Steagall aside, in the final policy maneuvering for any given law there are peripheral issues raised by policy entrepreneurs seeking to take advantage of the open policy window. In the case of GLBA, those policy issues revolved around the community reinvestment act, financial privacy, and protecting community banks in the post Glass-Steagall era. This section highlights the chief proponents and their positions on those three issues entering the 106th Congress.[520]

Community Reinvestment

Beginning with the legislative debates of the 105th Congress, both President Clinton and the new Senate Banking Committee Chair Phil Gramm took advantage of the open policy window for repealing Glass-Steagall to stake out opposing positions on the extent to which tenets of the Community Reinvestment Act (CRA) would be incorporated into financial services modernization. President Clinton's economic team strongly supported the efforts of community activists to expand the applicability of the CRA to a broader set of financial institutions beyond commercial banks. Treasury Secretary Rubin in particular convinced President Clinton to deploy the threat of veto to ensure that a CRA expansion would be part of the law. Gramm, on the other hand, was now in a position as Senate Banking Committee chair to block any legislation that did not address his concerns about expanding CRA provisions, including his desire to constrain the role

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[520] John W. Kingdon, *Agendas, Alternatives, and Public Policies* (Glenview, IL: Longman, 2011, 1984), 196-205.

of activists in the CRA rating process. The question in terms of financial modernization was whether or not the two sides could find common ground sufficient to allow financial modernization to proceed.

Community reinvestment aside, Gramm was personally committed to financial modernization based on his view that the original economic value proposition for Glass-Steagall was flawed.[521] He scheduled hearings on 25 February in order to preserve the momentum from the 105th Congress, and called for a compromise on CRA "that will allow us to move forward."[522] Yet in reality Gramm remained adamantly opposed to the CRA. Recall that he not only objected to expanding the CRA, he believed the original CRA to be flawed in implementation because it enabled community activists to force funding for their causes from banks in return for not opposing a satisfactory CRA rating. Gramm was unpersuaded by the arguments that CRA supporters offered that any such flaws were outweighed by the value of providing banking services in minority areas.[523]

Congressional Quarterly presented the community reinvestment dispute as a classic Washington power struggle among interest groups, lobbyists, and regulators for influence over the legislative process. The stated purpose of the Community Reinvestment Act of 1977 (12 USC 2901) was to encourage a financial institution to

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[521] Phil Gramm, Interview, January 16, 2018. Senator Gramm described briefing his Republican colleagues at the beginning of the legislative session so that they understood the principles that would guide his approach to the legislation. He referenced the academic studies that had demonstrated the conclusions of the Pecora Hearings were wrong.

[522] Parks, "Push Is On," 263–64

[523] Very briefly, the Community Reinvestment Act (PL 95-128) required banks to make loans and provide services to all segments of their communities. As a practical matter the law was aimed at ensuring banks provided services to minority and low-income populations. The CRA had strong enforcement provisions. In addition to fines federal regulators were authorized to block mergers and expansions of banks not in compliance.

meet the credit needs of all communities in which it operated. In practice, this meant that banks were evaluated on how well they met the credit needs of moderate and low-income communities in which it operated, consistent with safety and soundness.[524] Banks and their Republican supporters argued the law was a heavy-handed intrusion into the marketplace that distorted investment decisions and raised business risk. Community activists and their supporters among Democrats viewed the 1977 law as having been successful in bringing investment to impoverished areas, and claimed the banks were able to make a profit while doing so. As a result, the Clinton administration supported the law and was committed to veto any legislation that threatened it.[525]

Gramm aside, both sides found room to compromise on the issue. Even though the banking community would have preferred to get rid of the regulatory burden, bankers generally were resigned to some CRA provisions as likely. In fact, bankers had long since incorporated the current CRA requirements as a cost of doing business, and did not want the issue to be a line in the sand for financial reform. For their part, community activists demanded that full extent of the CRA be applied in the new financial modernization law. However, even among activists most accepted it was politically unrealistic to actually expand the applicability of the CRA outside of banking.[526]

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[524] The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (PL 101-73) amended the CRA to require public disclosure of certain aspects of each examination results. The grades that might be assigned range from "Outstanding" (record of meeting community needs), "Satisfactory," "Needs to Improve," to "Substantial Noncompliance." Further, as an enforcement mechanism, supervisory agencies were required to take this performance into account when considering approval of expansion or acquisitions by the financial institution.

[525] Parks, "Fuzzy Battle Lines," 491–93.

[526] Parks, "Fuzzy Battle Lines," 491–93.

Relative to banking reform, the first 1999 drafts of H.R. 10 in the House preserved the provisions from the 105th Congress that expanded the scope of the CRA. In the Senate, Gramm's version of the law eased CRA requirements on banks but did not seek to eliminate them entirely. In particular, the Senate bill deemed banks to be in compliance with the CRA if they were at least "satisfactory" on their most recent exam, and had been compliant for the three previous years. The Administration did not concur with the Senate approach. Comptroller Hawke argued it would put greater emphasis on the now infrequent examination process, which would add to administrative burden. Instead, Hawke stated that he "supports the approach taken in the House-passed version of H.R. 10, which would apply a satisfactory CRA requirement on an on-going basis as a condition to engaging in the new financial activities."[527]

Privacy

Another issue, consumer privacy and protection of information, became a consideration late in the debate during the 105th Congress. Differing bills were introduced in the House by H.R. 4321, and in the Senate by an amendment to H.R. 10 by Senator Richard H. Bryan, D-NV. Neither the House nor Senate versions were initially taken to be serious impediments to passing financial modernization legislation. This view was incorrect, as the Clinton Administration and congressional Democrats seized on the issue of consumer protection as an important counterpoint to the large financial conglomerates to be created by financial services modernization. In fact, President

[527] Hawke, "Comptroller Warns That Senate Proposal," 8.

Clinton announced a new Financial Privacy and Consumer Protection Initiative in March 1999.[528]

Clinton's privacy initiative may have been in the public's interest, but it was also created explicitly to provide a political agenda around which to rally Democrats in Congress. In an internal White House memo, National Economic Council Director Gene Sperling said, "This package will give Democrats numerous consumer protection proposals that they can advance that will earn enthusiastic Administration support." On the specific legislative strategy for financial privacy, he noted, "There is little prospect that a package of consumer financial protection initiatives will move as a whole in this Congress." However, Sperling recommended that pieces of the package could be considered in the context of other financial legislation such as financial modernization.[529]

The gist of the issue was that, assuming one advantage of financial services modernization was to allow cross-sharing of customer data, some controls were necessary to protect the consumers' privacy. Or, as President Clinton said in announcing his privacy initiative, privacy controls were necessary "to give all Americans the tools and confidence they need to participate in our thriving but highly complex 21st Century economy."[530]

The Federal Reserve took the position that, while in the past the market had provided effective remedies for financial institutions that lost the customer's trust, it was

[528] William Jefferson Clinton, "Consumer Financial Protection," Draft Remarks. The White House (March 18, 1999). Courtesy of the William J. Clinton Presidential Library & Museum.

[529] Gene Sperling, "Memorandum to Prepare for a Financial Privacy and Consumer Protection Event," The White House (May 3, 1999). Courtesy of the William J. Clinton Presidential Library & Museum.

[530] Clinton, "Consumer Financial Protection," March 18, 1999.

an issue of growing public concern and appropriate to address as part of financial modernization. Federal Reserve Governor Edward Gramlich noted that, "The Congress has already deemed it necessary to address specifically the uses of consumer financial information in the Fair Credit Reporting Act (FCRA). This Act governs the exchange of customer data by and with consumer reporting agencies."[531]

For its part, the SEC also found privacy to be an appropriate concern. SEC Director of Market Regulation Annette Nazareth testified, "The Commission supports the legislative efforts that are currently being made to enhance financial privacy." Although federal security laws had no specific provision on financial privacy, the SEC often took it upon itself to remind broker-dealers, transfer agents, investment advisors and companies that, as financial professionals, they should take reasonable precautions to protect confidentiality, integrity and security of financial information. Nazareth also noted that the SEC partners with the securities industry SROs on this matter. Indeed, the SEC believed that SROs had the authority to address privacy concerns, and in fact previously have exercised that authority in disciplining their members.[532]

From the perspective of the OCC, Comptroller Hawke observed in his testimony that while federal law addressed privacy in several places, notably the FCRA, the Privacy Act, and Electronic Fund Transfer Act, these laws only provided customers a limited choice about how their financial information may be used. Because the OCC found

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[531] The Fair Credit Reporting Act, 15 U.S.C. § 1681. See also Edward M. Gramlich, "Financial Privacy Issues," Testimony presented at the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services, U.S. House of Representatives, Washington, DC (July 21, 1999): 1-4.

[532] Annette L. Nazareth, "Concerning Financial Privacy," Testimony Before the Subcommittee on Financial Institutions and Consumer Credit, Committee on Banking and Financial Services, U.S. House of Representatives, Washington, D.C. (July 21, 1999).

financial privacy to be a genuine issue, it had been trying to improve measures that address financial privacy at national banks through the mechanism of advisory letters. The subjects of these advisories were pretext calling, FCRA affiliate information sharing, and prominent internet privacy policies. Hawke also believed that the federal banking regulatory agencies lacked authority to issue definitive regulations on privacy. He therefore supported the proposed privacy provisions in the House bill because "the privacy provisions in H.R. 10 will enhance the notice and choice requirements already existent under FCRA" by improving the enforcement of privacy provisions.[533]

Expanded Access to FHLB System

Chairman Leach was a long-time supporter of community banks, many of which were too small to take advantages of the affiliation benefits of the proposed financial modernization legislation. In his view, repeal of Glass-Steagall had little to offer these smaller banks and actually had some significant disadvantages. In particular, larger financial institutions with expanded reach would be difficult for small banks to compete with, but might not have the same commitment to the local communities.

In order to ensure that small banks remained viable, and to gain their support for H.R. 10, Leach proposed expanding access to the FHLB system for community banks in order to ensure they had access to capital in the event of localized business or farming downturns. Specifically, Leach increased the range of eligible collateral that banks could

[533] John D. Hawke, Jr., "HR 10 and Privacy," Testimony before the presented at the Subcommittee on Financial Institutions and Consumer Credit of the Committee on Banking and Financial Services U.S. House of Representatives, Washington, D.C. (July 21, 1999): 10; Julie L. Williams, "HR 10: The Financial Modernization Act of 1998," Testimony before the Committee on Banking, Housing, and Urban Affairs of the U.S. Senate, Washington, D.C. (June 25, 1998): 5. The OCC consistently supported privacy provisions.

offer for loans from the FHLBB from just mortgages to include portfolios of agrarian and small business loans.[534]

As discussed in Chapter 3, expanding access to the FHLB system for community banks was almost wholly driven by Leach. Gramm did not appear to oppose the expansion but neither had he included any such provision in Senate drafts. On the regulatory side, Greenspan was neutral on these provisions. Rubin opposed opening up the FHLB system on the grounds that it would dilute the original purpose of the banks, which was to foster home ownership. However, Rubin's opposition appeared to be more of a negotiating position for the Administration, which never seriously protested the proposal. Once Rubin announced his departure for Citigroup, there was little doubt that Leach would push though his FHLB loan expansion to community banks.[535]

Legislative Action

As a basic starting point for financial services modernization legislation in the 106th Congress, one must bear in mind that its predecessor bill only passed the House by one vote in the 105th Congress. A certain amount of political fractiousness remained to be resolved in both Houses. In order to stake out bipartisan support for a reprise in 1999, both House Banking Committee Chairman Leach and Ranking Member John LaFalce, D-NY made a joint statement after the first set of hearings on 10-11 February that they were "committed to working expeditiously and on a bipartisan basis to build on the progress we've made and achieve the maximum possible consensus on this much-needed

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[534] James A. Leach, "Working Papers," 2009/2010; Carnell and Baer, "Rethinking Financial Modernization Legislation," 8-11.

[535] Robert E. Rubin, "Financial Modernization and Its Effects on Our Nation's Economy," Testimony presented at the Senate Banking Committee, Washington, D.C. (June 17, 1998): 1-5.

legislation." Although Gramm's efforts in the Senate were more partisan, he did follow through on earlier commitments by holding hearings on 23-25 February.[536]

As a result of these hearings, both the House and Senate Banking committees passed bills early in 1999. Each repealed the Glass-Steagall Act of 1933 and the Bank Holding Company Act of 1956 prohibitions against merging banking, insurance, and securities firms, in a reflection of what *Congressional Quarterly* called a "widespread industry consensus that those laws are outdated and that they limit the international competitiveness of U.S. financial institutions." However, given the divergence of interests on the major issues, the Senate and House bills were at odds over several major provisions that would need to be reconciled among both Houses of Congress, and with the Administration.[537]

Leach's draft H.R. 10 was taken as a bipartisan effort in good faith, but several policymakers and interest groups opposed Gramm's version as taking a step back from the hard-won compromises in the 105th Congress. On the major issues, Rubin formally notified Senator Gramm that President Clinton would veto the bill if his concerns were not addressed on two issues. Rubin's first concern was language in Gramm's bill that actually scaled back the applicability of the CRA. His second was that Gramm did not allow banks to conduct insurance and securities activities in operating subsidiaries.[538] Regarding functional regulation, insurance agents objected to Gramm's bill for allowing

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[536] "Removing the Roadblocks?" *Insurance Advocate* 110, no. 7 (February 13, 1999): 1.

[537] Daniel J. Parks, "House Panel's Struggle for Accord Moves Financial Services Rewrite," *CQ Weekly* (March 13, 1999): 611–12.

[538] Robert E. Rubin, Gene Sperling, Bruce Reed, and Larry Stein, "Clinton Administration Positions on Financial Services Legislation," The White House (March 1, 1999). William J. Clinton Presidential Library & Museum.

federal regulation of banks' insurance sales. Bob Rusbuldt of the Independent Insurance Agents of America (IIAA) colorfully explained that, "We just about had a truce in the Civil War at the end of the last Congress, and now we're back in the trenches again." Finally, commercial bankers objected to provisions that would allow the use of unitary thrifts to expand. Even so, all parties understood that these objections were negotiating positions. As Edward Yingling, chief lobbyist for ABA, observed, "It would be in the interest of all parties to try to keep the process moving and see if we can't resolve some of these issues as the process moves forward."[539]

House Banking and Finance Committee

On the House side, H.R. 10 was passed by the House Banking and Finance Committee (51-8) on March 11. In keeping with their bipartisan approach, Leach reached an important agreement with Ranking Member John LaFalce, D-NY to permit banks to perform some nonbanking financial services in operating subsidiaries as well as in holding companies. This was a key concession to Secretary Rubin, who had set the Clinton administration position that a bill excluding the operating subsidiary option would be vetoed. On the other hand, Leach and LaFalce explained that their compromise left several important matters to be worked out with the Commerce Committee, including functional regulation and unitary thrifts.[540]

On community reinvestment, the other issue over which the President had threatened a veto, the House Banking Committee version of H.R. 10 took an expansive

[539] Lori Nitschke and Daniel J. Parks, "Gramm's Financial Services Rewrite Attacked as Coming Up Short on Community Investment, Insurance," *CQ Weekly* (February 20, 1999): 444–45.

[540] James Leach and John LaFalce, "Statement About the Bi-Partisan Markup of H.R. 10," March 1, 1999.

approach consistent with the Administration's policy preferences. These provisions were bound to set the House in opposition to the Senate Banking Committee's version, but reflected the bipartisan nature of the bill that Leach was crafting. For example, H.R. 10 would apply reinvestment provisions to some institutions that were not federally insured. It would make bank expansion into nonbanking activities subject to satisfactory community reinvestment reviews and imposed potential criminal penalties on banks that fail to correct poor ratings. Finally, Representative Barbara Lee, D-CA introduced an amendment, accepted 28-27, to prevent an insurance company from merging with either a bank or securities firm if was involved or had settled litigation over redlining, which was the practice of denying coverage or loans based on location of a residence.[541]

In a relatively new development, the House Banking Committee's version of H.R. 10 also introduced new financial privacy provisions. Representative Jay Inslee, D-WA

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[541] Daniel J. Parks, "The House That CRA Built: Redlining Law Revisited," April 24, 1999, 938–44; Daniel J. Parks and Lori Nitschke, "Clash Over Community Reinvestment Threatens Senate Financial Services Bill," *CQ Weekly* (March 6, 1999): 548–49. "Redlining" is a term for the systematic denial of loans by banks to minorities in identifiable low-income areas. The Community Reinvestment Act (CRA) (PL 95-128) was enacted in 1977 specifically to end redlining. The CRA functions in a straightforward way. Banks are required to document where they collect deposits and where they provide loans. The enforcement mechanism is that regulators must certify that banks are investing in all the neighborhoods that they do business, including low income neighborhoods, before a bank is authorized to open new branches or conduct mergers. Throughout the 1980s the law had limited impact, but from 1991 to 1998 the reinvestment commitments by banks to low income areas grew from $2.4B to $680B. The increase was attributed to community activists learning to work with the law and to pressure applied by federal regulators. Democrats were long term supporters of the CRA, whereas Republicans tended to view it as distorting the bank loan market. Some Republicans like Senator Phil Gramm go so far as to accuse the activist community of exploiting the law to force payments to the activist groups because cash grants to organizations like BRIDGE Housing, NPA, or NCRO have proven effective, through the good offices of the community groups, in helping banks get regulatory authorities to approve branches and mergers. Carol J. Galante, President and CEO of Bridge Housing counters that, "CRA or no CRA, I don't see it as extortion." Rather, she argues these grants are no different than any other corporate grant to local communities.

leveraged the pressure to get a financial modernization bill out of committee to call a vote for H.R. 10 to include a consumer protection provision for financial privacy. Inslee's amendment required customer notification if a bank intended to share private financial information, and it also allowed the customer a 30 day opt out period. Many members were uncomfortable with having to vote on the issue without time to consider alternatives, but felt compelled to include some nod to customer privacy once the issue was introduced. As Representative Brad Sherman, D-CA put it, "It is very difficult for many of us to vote against having a privacy component of this bill now that this issue has come up." In order to forestall banking industry opposition, Leach and Representative Bruce F. Vento, D-MN introduced an alternative that required customer notification but no "opt-out" provision. The Leach-Vento amendment was adopted into H.R. 10 (52-6).[542]

Senate Bill Passes

As the politics played out, the Senate process on financial services modernization legislation remained partisan and controversial. Gramm proved intransigent, specifically in his insistence on language that would exempt some or all of the new financial institutions from the Community Reinvestment Act. The American Insurance Association (AIA), a property and casualty insurance trade association, noted in an 8 March statement it was clear that Gramm intended a bill to be passed on his terms or not at all. Although Gramm did move his bill to the floor, the Senate Banking, Housing, and Urban Affairs Committee only passed the bill along party lines (11-9). At that point, Senator Christopher J. Dodd, D-CT remarked, "We're about to have a train wreck here over this

[542] Parks, "House Panel's Struggle," 611–12

(CRA) issue."[543] This partisanship was significant both for the vote of the full Senate, but also because Gramm would need the votes of Democratic senators if President Clinton made good on his threats to veto the bill if it included language preempting the CRA.[544]

In March 1999, the Senate Banking Committee also approved two key amendments. One offered by Senator Richard Bryan, D-NV would overturn the *Barnett* standard for insurance sales.[545] The U.S. Supreme Court ruling in the *Barnett* case in 1996 was a true watershed moment for the insurance industry because it established the precedent that national banks were allowed to sell insurance under the authority of the OCC, not state insurance commissioners.[546] At the federal level the insurance trade associations, led by the National Association of Life Insurance Underwriters, advocated for functional regulation to separate banking and insurance, even at the same bank. This was formally introduced into the Senate's bill by the Bryan Amendment, which required that the business of insurance, including insurance in banking sales, be functionally regulated. In practice, since insurance was regulated by state commissioners, this was a requirement that insurance regulation be reserved to the states. In a major victory for the

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[543] Parks and Nitschke, "Clash Over Community Reinvestment Threatens Senate Financial Services Bill," 548–49.

[544] Robert D. Hogue, "H.R. 10--The Final Move?" *Insurance Advocate* 110, no. 10 (March 6, 1999): 1.

[545] "The Churning Continues," *Insurance Advocate* 110, no. 11 (March 13, 1999): 1.

[546] The *Barnett* ruling provided that a state could only regulate national bank insurance sales if it did not "prevent or significantly interfere" with a national bank's authority as interpreted by the OCC. This interpretation was strongly opposed by the National Association of Life Insurance Underwriters (NALU), which worked to undermine it at both the state and federal level

insurance agents, if a bank sold insurance then the Bryan Amendment required that the sales must be done by state licensed insurance agents.[547]

The second crucial amendment, offered by Senator Richard Shelby, R-AL exempted banks with assets less than $100 million from the requirements of the CRA.[548] Senator Shelby's CRA amendment was fully supported by Chairman Gramm. Although Gramm and Shelby were able to hold the Republican majority on the Banking Committee together in support of the reinvestment "rural exemption," the support for this approach was weak. In fact, Edward Yingling stressed that neither the major banking trade associations nor their constituents were specifically supporting Gramm in his opposition to the CRA.[549]

On the other hand, community reinvestment activists passionately opposed Gramm and Shelby's provision on multiple grounds. First, they feared Gramm's CRA provisions were merely a first step in a longer-term effort to unwind the CRA. Second, in a counter to Gramm's claim that the impact of the $100 million provision would be modest, they argued that it would apply to 40% of lenders and over 72% of rural lenders. Finally, they argued that even if Gramm were right that redlining was less of an issue in rural communities, local banks could still shortchange low-income communities by choosing to invest in securities rather than loans. The Clinton administration was

[547] Hogue, "Financial Services Modernization," 38.

[548] "The Churning Continues," *Insurance Advocate* 110, no. 11 (March 13, 1999): 1.

[549] Gramm, Interview, January 16, 2018; "Where Gramm Draws the Line," 944.

completely aligned with the activists in staunch support of the CRA, and re-issued a veto threat if Gramm's bill passed the Senate in its current form.[550]

In a milestone, the Senate passed Gramm's bill, now numbered S.900, on largely partisan lines (54-44), with Senator Ernest F. Hollings, D-SC the sole democrat to vote for the bill. Gramm himself acknowledged the bill was subject to presidential veto over its provisions to weaken the CRA, but expressed confidence that a compromise could be worked out in conference with the House. During the three-day floor debate Gramm produced the evidence he had promised to back his oft repeated claim that community groups were leveraging the CRA to extort funds from banks. Gramm claimed that the documents were from community groups who promised to withdraw complaints to improve a bank's reinvestment ratings in exchange for cash contributions. Gramm said, "this is about abuse," and added that his bill sought to correct a "wrong going on in America." Democrats, including Senate Banking, Housing, and Urban Affairs Committee ranking member Paul S. Sarbanes, D-MD, argued that the bill was too sweeping to compensate for isolated cases of abuse.[551]

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[550] Daniel J. Parks, "House Panel's Struggle," 611–12; Parks, "The House That CRA Built: Redlining Law Revisited," April 24, 1999, 938–44.

[551] Daniel J. Parks, "Senate Passes Banking Overhaul Bill Vulnerable to a Clinton Veto; House Version Divides Committees." *CQ Weekly* (May 8, 1999): 1081–82. See also Gramm, Interview, January 16, 2018; Abernathy, Interview, January 23, 2018. During the floor debate an amendment by Senator Richard H. Bryan, D-NV to strip S.900 of Gramm's reinvestment provisions was defeated (52-45), as was an alternative version of S.900 offered by Sarbanes (54-43). Interestingly, the issue that almost killed Gramm's legislation on the Senate floor was not the CRA discussion, but federal regulatory structure. In something of a surprise, it came from his Republican ally on the Senate Banking Committee, Richard C. Shelby, R-AL. Gramm's version of S.900 generally adhered to the regulatory structure advocated by Federal Reserve Chairman Alan Greenspan, which required merged financial entities to be organized as holding companies subject to the jurisdiction of the Federal Reserve. Shelby introduced an amendment that would have allowed operating subsidiaries, suggesting the structure was

On the issue of unitary thrifts Gramm's bill followed the House lead in merely preventing the establishment of any new thrifts by commercial companies. Senator Tim Johnson, D-SC introduced an amendment to go further and prevent the acquisition of any current thrifts by commercial companies. Despite Gramm's opposition, the amendment was passed by voice vote. Both versions grandfathered existing commercial companies that owned unitary thrifts.[552]

Action Moves to Commerce Subcommittee on Finance and Hazardous Materials

In the House, H.R. 10 was referred from the House Banking Committee to the House Commerce Committee. In addition to the House practice of sequential referral to multiple committees with joint jurisdiction, Commerce Committee Chair Thomas J. Bliley, R-VA had been waiting to take up H.R. 10 pending Senate action. Bliley in turn first referred H.R. 10 to the Commerce Subcommittee on Finance and Hazardous Materials, chaired by Congressman Mike Oxley, R-OH.[553]

The insurance industry expected a sympathetic hearing in Commerce. Testifying on behalf of the IIAA and other groups of agents, counsel Scot A. Sinder told the House Commerce Committee Subcommittee on Finance and Hazardous Materials that, "IIAA has one basic concern regarding H.R. 10: ensuring that every entity that is involved in the insurance business is subject to state regulation." Repeating an insurance industry staple, he further argued, "Federal banking regulators are in no position to substitute for the

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more flexible for the merged financial firms to address the international competitiveness issue and claimed it would not endanger the banking system. Gramm threatened to pull the bill if the amendment passed. The debate was tumultuous, with six Democrats and seven Republicans breaking from party ranks, but the Shelby amendment was eventually tabled (53-46). Both Gramm and Abernathy cite Shelby's Alabama colleague, Senator Sessions, R-AL as crucial to tabling Shelby's amendment.

[552] Parks, "Senate Passes Banking Overhaul Bill," 1081–82.

[553] Parks, "Senate Passes Banking Overhaul Bill," 1081–82. At this point, H.R. 10 had incorporated elements from Representative LaFalce's H.R. 665.

comprehensive state insurance laws that have developed over the last century."[554] Separately, IIAA Executive Vice President Robert A. Rusbuldt indicated that the proposed NAIC amendments would meet the IIAA's needs. "The NAIC proposal addresses the functional regulation and consumer protection concerns that IIAA has with H.R. 10," said Rusbuldt. "If the NAIC package is adopted IIAA would then be in the position of supporting the House reform proposal."[555] Robert Dibblee, executive vice president of the National Association of Independent Insurers (NAII), commended the committee for including in its mark-up most of the proposed NAIC amendments. Although the NAII and NAIC noted that the subcommittee did not adopt all of their recommendations, they supported the bill for approval by the full House Commerce Committee.[556]

Beyond functional regulation, several other issues remain contentious among the House Commerce and Banking Committees as well as with the Senate bill (S.900). The surprise issue of the 106th Congress remained consumer privacy. Democrats seized on the issue and worked hard to restrict corporate use of private information. Republicans generally supported the industry desire to make better use of consumer data. Indeed, cross-selling was said to be a key advantage of allowing banking, securities, and insurance firms to merge. But they also acknowledged that the privacy issue had become a concern for some of their constituents. Representative W.J. "Billy" Tauzin, R-LA

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[554] "IIAA Testimony at Hearing Cites Absolute Need of Clarification and Strengthening of Oversight, Regulation of Insurance Providers," *Insurance Advocate* 110, no. 19 (May 8, 1999): 1.

[555] IIAA, "Need of Clarification and Strengthening of Oversight, Regulation of Insurance Providers,"1.

[556] "H.R. 10 Moves Again," *Insurance Advocate* 110, no. 23 (June 5, 1999): 1. For example, the subset of "safe harbor" provisions removed by the Banking Committee were not restored.

suggested that customers would benefit from information sharing because companies could direct to them products and services that would meet their needs.[557]

Ultimately the Subcommittee adopted by voice vote an amendment by Subcommittee Chair Michael G. Oxley, R-OH to require that companies disclose their information sharing policies to consumers. Similar to the provision adopted by the House Banking Committee, it addressed the issue but left action to consumers who could leave the bank if they disagreed with its policies. Democrats argued Oxley's amendment did not go far enough. Representative Edward J. Markey, D-MA offered an amendment to require consumer permission to share data, but it was defeated (8-19). Markey derided lobbyists claims of "unintended consequences" if data sharing were blocked, saying that they just sought to use the private data for profit. He said, "They don't want anybody to have the right to say no." The fight was expected to continue on the full committee as ranking Democrat John Dingell supported Markey's amendment.[558]

Unitary thrifts were another major contentious issue. The Commerce Subcommittee on Finance and Hazardous Materials had a strenuous debate on the issue of unitary thrifts being purchased by commercial firms, which had been contentious for both the Senate and House Banking and Finance Committee. The issue crossed party lines. There appeared to be general agreement to prevent new thrifts from being purchased by commercial firms. Although H.R. 10 initially allowed the affiliation of thrifts with commercial firms, an amendment by Representative Steve Largent, R-OK was adopted (15-3) by the subcommittee to reverse that position and prohibit such sales

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[557] Daniel J. Parks, "GOP Thwarts Democrats' Effort to Toughen Privacy Protections in Financial Services Overhaul Bill," *CQ Weekly* (May 29, 1999): 1285–86.

[558] Parks, "GOP Thwarts Democrats' Effort to Toughen Privacy," 1285–86.

of thrifts to commercial firms. The subcommittee's version now aligned with the Senate's bill S.900, but was in opposition to the House Banking Committee's mark-up.[559]

Finally, the Subcommittee took up the holding company versus operating subsidiary issue. Even after the House Banking Committee bill allowed operating subsidiaries for banks less than $10B in assets, Alan Greenspan remained completely opposed. He stated that, "I and my colleagues…are firmly of the view that the long-term stability of U.S. financial markets and the interests of the American taxpayer would be better served by no financial modernization bill rather than one that allows the proposed new activities to be conducted by the bank, as proposed by H.R. 10." As a result, *Congressional Quarterly* reported that industry observers expected the Commerce Committee to adopt the holding company affiliate regulatory structure preferred by the Federal Reserve.[560]

The Subcommittee voted to approve an amended version of H.R. 10 on May 27. The mark-up was generally bipartisan, preserving the compromises for the 105th Congress as the bill was passed to the full committee (26-1). After mark-up, the Commerce Subcommittee on Finance and Hazardous Materials bill would not allow banks to conduct nonbanking activities in subsidiaries and instead required them to be placed in a holding company structure. This was reasonably well aligned with S.900, but sharply different than the position taken by the House Banking Committee. It also placed the subcommittee in direct opposition to the Clinton Administration, which at Secretary

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[559] Parks, "GOP Thwarts Democrats' Effort to Toughen Privacy," 1285–86.

[560] Alan Greenspan, "Chairman Board of Governors of the Federal Reserve System on HR 10," Testimony presented at the Subcommittee on Financial and Hazardous Materials of the Committee on Commerce U.S. House of Representatives, Washington DC (April 28, 1999): 3.

Rubin's urging had threatened to veto the bill if operating subsidiaries were not allowed. Finally, the subcommittee's bill would give greater authority to state insurance regulators over the insurance activities of national banks. This was a win for insurance agents but created another point of contention with the House Banking Committee mark-up of H.R. 10.[561]

Full House Commerce Committee Deliberations

Since the Commerce Committee had jurisdiction over securities matters, SEC Chairman Levitt focused here to indicate his serious reservations about the current version of H.R. 10. Although he supported the H.R. 10 version from the 105th Congress, the bill had evolved too much since then for Levitt. Indeed, he claimed, "H.R. 10 now creates too many loopholes in securities regulation – too many products are carved out, and too many activities are exempted." Levitt argued that the exceptions would prevent the Commission from "protecting U.S. markets and investors."[562]

In reality Levitt was asking for a full implementation of functional regulation that gave the SEC jurisdiction over all securities activities. The SEC would have that authority anyway for affiliates of banks that engage in securities activities, but Levitt pointed out it would be most consistent for the Commission to regulate securities activities in banks as well. Noting that banks have held a historical exemption from oversight by the SEC for those securities products they were authorized to underwrite and

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[561] Daniel J. Parks, "Let's Make a Deal: Banking Bills Evolve Behind the Scenes," *CQ Weekly* (May 22, 1999): 1184; Parks, "GOP Thwarts Effort to Toughen Privacy," 1285–86. House Speaker J. Dennis Hastert made private statements that indicated the President would give on this issue if the House would protect the CRA.

[562] Arthur Levitt, "SEC Testimony on H.R. 10," Presented at the Committee on Commerce of the U.S. House of Representatives, Washington, D.C. (May 5, 1999): 1-10. For example, H.R. 10 as marked-up included exemptions for hybrid products, derivatives, trust activities, and private placements.

sell, he argued that financial modernization must ensure that, “In order for banks to be fully liberated from the outdated Glass-Steagall Act restrictions on their ability to conduct securities activities, banks must be willing to take on the responsibility for full compliance with U.S. securities laws.”[563] Levitt’s view was that, “The Commission cannot vigorously protect the integrity of U.S. markets and adequately protect investors with one hand tied behind its back.”[564] While this was a logically consistent argument, it was not a winning one. As Greenspan pointed out, banks had been adequately supervising securities activities for years. In any event, banking examiners were willing to give up authority over new products, but not the authorities they already had.[565]

On the other hand, Levitt was aligned with Chairman Greenspan on the holding company structure versus the operating subsidiary structure. In the first place, this would make separate securities affiliate more likely, which would come under the SEC’s jurisdiction. He also specifically called out his support for broker-dealer holding companies, which would come under the SEC’s jurisdiction.[566] Within the holding company construct, Levitt also argued that the SEC should receive deference with respect to securities functions, just as bank examiners are deferred to as regards depository institutions. His point was that bank and securities regulation have different purposes:

> There is a fundamental difference between the Commission’s program and that of the bank regulators. Bank regulators are concerned about the safety and soundness of banking institutions and the prevention of bank failures. The Commission, on

[563] Levitt, “SEC Testimony on H.R. 10,” 3.

[564] Levitt, “SEC Testimony on H.R. 10,” 3-4;

[565] Wayne Abernathy, Interview, January 23, 2018.

[566] Levitt, “SEC Testimony on H.R. 10,”10. Such broker dealer holding companies would include wholesale financial institutions (WFI), or “woofies.” The particular advantage of WFIs to the broker-dealer holding company was that they could be given access to the federal payment system maintained by the Federal Reserve.

the other hand, focuses on disclosure, investor protection, and the maintenance of fair and orderly markets.

Levitt's underlying argument was that, "The Commission's fundamental mission is the same whether the securities firm is affiliated with a bank, an insurance company, or has no affiliations at all."[567]

Given the Commerce Committees jurisdiction over insurance matters as well as securities, the insurance trade associations also considered this mark-up their best chance to insert provisions beneficial to the insurance industry.[568] The National Association of Insurance Commissioners (NAIC), which often substituted for federal oversight of the insurance industry by providing nationally coordinated insurance policies and model state legislation, took a strong stand in April 1999 by offering the House Commerce Committee a series of amendments to strengthen the provisions of H.R. 10 concerned with the state regulation of insurance. Under the NAIC's leadership, the insurance industry argued the amendments were necessary to clarify the regulatory approach to insurance and banking products. In particular, these amendments preserved state insurance regulation, protected consumers of insurance products, and provided the clarity necessary to prevent litigation on the boundaries between insurance, bank or security products.[569]

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[567] Securities and Exchange Commission, "Concerning Bank Securities Issues," Statement to the Subcommittee on Oversight and Investigations Committee on Commerce, U.S. House of Representatives, Washington, D.C. (June 25, 1999).

[568] "Next Stop--Commerce Committee," *Insurance Advocate* 110, no. 12 (March 20, 1999): 1.

[569] George M. Reider, Jr. and George Nichols III, "NAIC Letter to Chairman Bliley and Ranking Member Dingell," 22 April 1999; "NAIC Proposed H.R. 10 Amendments," *Insurance Advocate* 110, no. 18 (May 1, 1999): 1. Several other insurance trade associations offered support of the NAIC amendments, including the National

Finally, privacy turned out to be a surprisingly contentious issue during the full Commerce Committee debate. After a vigorous debate, a compromise measure offered by Representative Paul E. Gillmor, R-OH was accepted by the committee. This amendment did not require permission from customers, but allowed customers to "opt out" of information sharing among affiliates and third parties.[570]

What the financial services industry objected to were privacy provisions that would inhibit their ability to share or sell data about their customers. Brian C. Conklin of the Financial Services Council, which represented large banks and insurance companies, claimed "most if not all" of its members would object to inserting privacy provisions in the bill. Conklin indicated that industry could accept a limited "opt out" provision for third party sharing but was adamantly opposed to restrictions on sharing among affiliates. Both the AIA and SIA also announced that they opposed the privacy measures.[571]

Reconciling H.R. 10 in the House

On 10 June, the House Commerce Committee passed H.R. 10 by unanimous voice vote.[572] Since the House Banking and Finance Committee and Commerce Committee shared jurisdiction over the financial services industry, their two competing versions of H.R. 10 were then required to be sent to the Rules Committee, where Republican leaders had to resolve differences over privacy, unitary thrifts, and regulatory

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Association of Independent Insurers (NAII), the Independent Insurance Agents of America (IIAA) and the National Association of Life Underwriters (NALU).

570 Daniel J. Parks, "Industry Prepares for Floor Fight Against Privacy Protections in House Financial Services Bill," *CQ Weekly* (June 12, 1999): 1378–79.

571 Parks, "Industry Prepares for Floor Fight,"1378–79.

572 "A Unanimous Vote/Industry OK." *Insurance Advocate* 110, no. 25 (June 19, 1999): 1.

oversight before taking the bill to the House floor. Differences with the Senate over S.900 would have to wait until the joint conference on the two bills.[573]

In order to help shape the debate, the White House released a statement of Administration policy declaring that it strongly opposed S.900, and would veto it if it passed as written. The President elaborated:

> In its current form, the bill would undermine the effectiveness of the Community Reinvestment Act (CRA)… The bill would unjustifiably deny financial services firms holding 99 percent of national bank assets the choice of conducting new financial activities through subsidiaries… The bill would also inadequately inform and protect consumers under the new system of financial products it authorizes… The Administration has serious concerns about mixing banking and commercial activity under any circumstances, and these concerns are heightened by the financial crises affecting other countries over the past few years…The Administration also opposes the bill's piecemeal modification of the Federal Home Loan Bank System."[574]

Republican leaders in the House worked to reconcile the versions of H.R. 10 from both the House Banking and Finance Committee and the House Commerce Committee over the next several weeks after the 10 June Commerce Committee vote. Lobbying on the bill was intense as it appeared that a financial modernization law was within reach. In general, the Banking Committee positions prevailed, but the jurisdictions of both committees were given due consideration. As House Majority Leader Dick Armey, R-TX said at a 22 June press conference, "We're not likely to pass this bill if either of the two chairmen are not in agreement."[575]

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[573] Parks, "Industry Prepares for Floor Fight," 1378–79.

[574] William Jefferson Clinton, "Statement of Administration Policy: S. 900 - Financial Services Modernization Act of 1999," The American Presidency Project (May 3, 1999). The veto threat was against S.900 because it had passed, and the Administration was trying to shape H.R. 10.

[575] Daniel J. Parks, "Financial Services Overhaul Bill Heads for House Floor," *CQ Weekly* (June 26, 1999): 1544–46.

Industry leaders met with the White House on 14 June to exchange views with high ranking members of the administration. According to one participant, the administration emphasized that its concerns were primarily to preserve the operating subsidiary structure and to preserve the community reinvestment provisions. While the White House expressed a willingness to be open on the issue of privacy for consumer data, the senior officials also noted that there had been a groundswell of popular sentiment in favor of protections as H.R. 10 evolved.[576]

The reconciled version of H.R. 10 that would be taken to the floor included the following positions on the major issues. One key point of agreement was that H.R. 10 would repeal the portions of 1933 Glass-Steagall Act and the 1956 Bank Holding Company Act that prevented the affiliation of commercial banks, investment banks, and insurance firms. In deference to the position taken by the Treasury and the administration, which had threatened a veto, the House bill would permit banks to hold nonbanking activities in operating subsidiaries, with the exception of insurance underwriting and real estate development. However, the expectation among the Banking Committee staff was that the leadership would allow a floor amendment that would require a holding company structure, the position preferred by Chairman Greenspan and the Federal Reserve.[577]

At this point, Rubin and Greenspan remained at odds over the operating subsidiary issue, which Congress could not resolve alone. And even though Rubin had already announced his planned departure, he had already convinced President Clinton to veto any financial modernization law that did not at least allow an option for an operating

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[576] Parks, “Overhaul Bill Heads for House Floor,”1544–46.
[577] Parks, “Overhaul Bill Heads for House Floor,” 1544–46

subsidiary structure. In an attempt to resolve the impasse, Rubin offered a compromise to restrict underwriting by bank operating subsidiaries to securities only. Both insurance underwriting and real estate development not be allowed in bank subsidiaries, but would permitted in affiliates owned by a bank holding company. Even though the Fed would regulate the latter and the OCC the former, Greenspan remained unmoved. He said, "No financial services operations-not even securities underwriting-should be in a bank operating subsidiary."[578]

Regarding privacy, the House leaders adopted the Banking Committee's consumer notification requirements but aligned with finance industry preferences and did not include the Commerce Committee's "opt-out" provisions. Again, given popular interest in the issue House leaders were expected to allow a floor vote on an amendment to adopt a stronger privacy measure, but many Members remained unsettled on pushing sweeping privacy measures before the issue was thoroughly vetted. For example, while the SEC supported privacy measures in the bill, the securities industry did not believe they were actually necessary because of the authorities granted the associational self-regulating organizations (SROs). According to the SEC's Nazareth, "We believe that SROs, which are required to have rules to promote just and equitable principles of trade, have the authority to address privacy concerns. SROs have used this authority to bring disciplinary actions." Given that, she said, "The SEC needs clear Congressional guidance to provide to the SROs on permissible enforcement activities."[579]

House leaders attempted a new compromise position on the issue of unitary thrifts in H.R. 10 by prohibiting thrifts from aligning with commercial firms unless approved by

[578] Hogue, "Financial Services Modernization," 38.
[579] Nazareth, "Concerning Financial Privacy," July 21, 1999.

the Federal Reserve. Since the Federal Reserve was historically opposed to mixing thrifts with commercial firms it was unclear what the impact of this provision would be. Both committee versions already agreed on community reinvestment provisions, so no reconciliation was necessary. In opposition to the Senate, H.R. 10 would require satisfactory community reinvestment ratings before mergers among financial entities could be approved. The House version aligned with the administration's preferences.[580]

Historic First: Both Houses Vote to (Partially) Repeal Glass-Steagall

One month later, on 1 July, the Financial Services Reform Act (H.R. 10) was passed by the U.S. House of Representatives (343-86). The vote was historic in that it marked the first time since the Glass-Steagall Act was passed in 1933 that both houses of Congress voted to repeal the law in the same session. As passed by the House, H.R. 10 was a compromise between the versions passed by the House Banking and Commerce Committees.[581]

A major difference in the final passage of H.R. 10 in the 105th Congress and the 106th was the bipartisan support the bill received from Democrats. Of the 343 who supported H.R. 10 in 1999, 130 had changed their vote from 1998. Democrats reported that there were two primary reasons for their support. The first was the new provisions in the bill to protect consumer privacy of both financial and health records. The second was that the Clinton administration supported the new version of the bill. This begs the question of course. The administration changed its position primarily because H.R. 10 revised its organizing construct from holding companies, as preferred by Chairman Greenspan and the Federal Reserve, to allowing banks to hold operating subsidiaries for

[580] Parks, "Overhaul Bill Heads for House Floor," 1544–46.

[581] Daniel J. Parks and Lori Nitschke, "Financial Services Overhaul Sees Home Stretch at Last," *CQ Weekly* (July 10, 1999): 1675–77.

insurance and securities activities as preferred by Secretary Rubin and the Treasury. The administration also largely got its way on community reinvestment, which H.R. 10 applied to the planned new merged financial entities.[582]

From another perspective, the most important difference from 1998 was that by 1999 the disputes among the major financial services industry players had largely been resolved. The general consensus that the Depression-era financial services regulatory structure required updating had existed for years. Yet disputes had persisted both for competitive advantages among the industries and over specific issues at law such as consumer privacy, community reinvestment, and regulatory oversight. Finally, in 1999 there was enough of a consensus in the private sector to allow the bill to succeed. Robert A. Rusbuldt, chief lobbyist for Independent Insurance Agents of America (IIAA), explained that, "You had the IIAA and the American Bankers Association supporting the bill. We have been throughout the last 20 years the two major players. Usually, it was one or the other supporting or opposing. That dynamic didn't exist this time."[583]

In any event, at this point in the process, the major industry players were in support of H.R. 10, including the ABA, IIAA, AIA, SIA, the Council of Insurance Agents & Brokers, the Financial Services Roundtable, and America's Community Bankers. That is not to say each group might not seek to influence specific provisions during conference negotiations, but only one major industry group, the Independent

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[582] "House Key Votes -- Financial Services," *CQ Weekly* (December 4, 1999): 2933; Parks and Nitschke, "Home Stretch at Last," 1675–77.

[583] Parks and Nitschke, "Home Stretch at Last," 1675–77. While the securities industry were major players in DC, both the banking and insurance industries were also able to muster strong grass roots pressure at the state and regional level. For example, Southern and Midwestern states tended to be sympathetic to positions taken by the smaller bankers and insurance brokerages whereas the financial centers on the coasts typically sided with the big commercial and insurance companies.

Community Bankers of America (ICBA), specifically opposed the bill over a policy issue. According to Kenneth A. Guenther, the ICBA objected to the unitary thrift provisions in H.R. 10, which would allow thrifts to affiliate with commercial companies after receiving permission from the Federal Reserve. The community bankers preferred the position taken in S.900 that would prevent new and existing thrifts from affiliating with commercial firms.[584]

Reconciling the House and Senate Versions

H.R. 10 was then moved to Joint Conference to resolve differences between it and the Senate version, S. 900. Both banking committee chairs were cautiously hopeful. Leach commented, “I'm optimistic, but I can give no assurances of anything.” And Gramm said after the 1 July vote by the House, "We now have it within our grasp to pass a good bill … (but) we face some very high hurdles, and negotiations will require a tremendous effort."[585]

There were of course several issues that were expected to be contentious in conference. In particular, regarding privacy, the House adopted a floor amendment (427-1) that would require a merged financial entity to offer consumers the right to “opt-out” of the disclosure of financial information to unaffiliated third parties. The Senate version contained no such “opt-out” provisions. In addition, the Senate bill would scale back the applicability of the CRA to the merged financial conglomerates in opposition to the position taken by H.R. 10 and preferred by the administration. S.900 would also require banks to conduct all non-bank financial activities under a holding company structure,

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[584] Parks and Nitschke, “Home Stretch at Last,” 1675–77.

[585] Daniel J. Parks, “Vote Margin on Financial Services Rewrite Gives House Leverage on Privacy Issues,” *CQ Weekly* (July 3, 1999): 1618–19.

which was the preferred position of the Federal Reserve. However, H.R. 10 allowed banks to conduct some financial activities such as securities and insurance through operating subsidiaries, as preferred by the Treasury and White House. Finally, although not expected to be a major fight, the different approaches to unitary thrifts did require compromise.[586]

At first, conference negotiations were moving slowly. In an unusual move to break the logjam, Gramm suggested at the 29 September conference meeting that he, Leach, and House Commerce Committee Chair Thomas Bliley meet privately to merge the two competing versions of the bill. Conferees would only have the opportunity to offer amendments after the basic bill had been shaped. Although Leach opposed this move, preferring open debate as the best means of ensuring support from Democrats to avoid a veto by President Clinton, Gramm argued that, "Part of being in the majority is having the obligation to lead." In any event, Gramm made clear that if the bill were going to move that year it would have to be his way. At a closed-door meeting among the three committee chairs, House Speaker Dennis J. Hastert, R-IL, and Senate Majority Leader Trent Lott, R-MI, the Republican leadership accepted Gramm's plan as the best way to accommodate heavy financial services industry pressure to move the bill before Congress adjourned. In a key concession, Gramm committed to supporting the bill that emerged even if it included amendments he opposed.[587]

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[586] Parks, "Vote Margin on Financial Services Rewrite Gives House Leverage on Privacy Issues," 1618–19. See also Appendix 6 for comparison of the Senate and House bills entering conference.

[587] Daniel J. Parks, "New Strategy Debated for Banking Bill," *CQ Weekly* (October 2, 1999): 2308. One issue with Leach's preferred approach was the unusually large conference committee, with 20 senators and 46 representatives. Such a large conference made progress unlikely with open debate to shape the bill.

Trade Associations Ramp Up Lobbying Pressure

A significant part of Hastert and Lott's willingness to go along with Gramm's approach was the pressure that Congressional leadership was receiving from industry lobbying groups. "This bill must pass," stated Carroll A. Campbell Jr., president and CEO of the American Council of Life Insurance. On 29 September leaders of the three major financial services industries met with Senator Lott to deliver a simple message: they wanted a bill this year and were willing to accept difficult compromises to get it. Having finally reached consensus that the Depression-era banking laws required modernization, and agreed on compromises among the industries as to the basic shape of the new regulatory structure, the financial industry was fearful of squandering the opportunity by having the bill get hung up in the House-Senate conference. And that risk appeared very real. Senator Chuck Hagel, R-NE remarked that if the bill were not moved in the next few weeks "this thing will just die of its own weight…I don't think time is on our side here."[588]

Having seen their efforts at reforming the regulatory framework fail repeatedly, industry was in no mood to see the efforts fail or even be postponed another year. As Kenneth A. Guenther of the ICBA said of almost everyone involved in the issue, "They are just sick and tired of this, and they want it off their backs." In addition to meeting with Congressional leadership, the industry presented a unified message to the media and public. Unlike past years in which public messages were delivered with industry specific positions staked out, when the Financial Services Coordinating Council (FSCC) met with

[588] Daniel J. Parks, "United at Last, Financial Industry Pressures Hill to Clear Overhaul," *CQ Weekly*, October 9, 1999, 2373–75; Daniel J. Parks, "Banking Bill Conference Off to Slow Start," *CQ Weekly*, September 25, 1999, 2234. The conferees were debating S.900 under Senate Report 106-44 and House Report 106-74, Parts 1-3.

reporters on 30 September it represented a united front committed to getting a bill to codify a new regulatory framework. Or, as Marc E. Lackritz, president of the SIA put it, "We now have a common front."[589]

Privacy: Industry Draws a Line

As it evolved, the single issue that caused the financial services industry to object to the conference bill was customer privacy. The red line for the financial services industry appeared to be "opt-in provisions," which they opposed. The conferees were not expected to go that far as neither the House nor Senate versions carried the "opt-in" provision desired by consumer advocates and championed by Democrats. In fact, observers at the time did not expect the final bill to obtain provisions any more demanding than those in the House bill, which required customers to be offered provisions to "opt-out" of third-party information sharing and required banks to disclose their information sharing policies. The Senate bill contained neither provision.[590]

In the meanwhile, from the Republican perspective a surprise issue emerged as Senator Richard C. Shelby, R-AL announced that he supported significant new limits on the ability of financial services firms to sell or share customer data. Shelby did not announce what specific privacy provisions he endorsed, so it was unclear how his position would affect negotiations. The House version included "opt-out" provisions for customers, but the Senate version did not. The financial services industries indicated they were willing to accept notification requirements about uses of customer data, but that they remained opposed to "opt-out" provisions or stronger "opt-in" provisions that would require banks to get approval before use of data. Not only would data sharing generate

[589] "Senate Key Votes -- Financial Services," *CQ Weekly*, December 4, 1999, 2941; Parks, "United at Last," 2373–75.

[590] Parks, "Banking Deal Appears at Hand," 2374.

potentially huge sources of revenue, the banks maintain that restrictions will make key activities like fraud prevention more difficult.[591]

Although a relatively new issue in the financial modernization debate, privacy was one of several issues that could have totally derailed the legislation in 1999, primarily because there was no consensus. Indeed, the House and Senate had taken different approaches. Consumer advocates made the most gains with the House, where their slim majority led Republicans to give ground to a strong Democratic push for privacy protections both in committee and on the floor. Even after the bill was passed, the pressure continued. The Consumers Union argued that the House privacy provisions were flawed. It stated in a 20 July news release that, "We believe that consumers have a right to decide whether their personal financial data is for sale to the highest bidder or can be shared with a multitude of affiliated companies." Partially as a result of this campaign, even though H.R. 10 as passed included only relatively mild "opt-out" provisions, on 30 July the House instructed its conferees (241-132) to push for "the strongest consumer financial privacy protections possible."[592]

Representatives of the banking, securities, and insurance sectors then all came together to oppose strong measures on the privacy of financial information. As explained by L. Richard Fischer, testifying on behalf of the Financial Services Roundtable, "The ability to share information and out-source banking operations heightens efficiency and

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[591] Daniel J. Parks, "Conference Roster Dispute, Shelby's Defection on Privacy Cloud Financial Services Outlook," *CQ Weekly* (August 7, 1999): 1943.

[592] Parks, "Privacy Has Banks on the Defensive," 2054–55; Joel Wood, "Remarks to the A.M. Best Life Conference of the CIBC World Markets," New York, NY, September 28, 1999. Wood, senior vice president of the Council of Insurance Agents and Brokers (CIAB), offered another rationale. He pointed out that "the public doesn't care about the regulatory or CRA issues. They care about privacy and confidentiality of medical and financial records."

promotes competition in the financial services sector, to the ultimate benefit of consumers." Financial industry representatives and regulators found stronger support in the Senate, where Senate Banking Committee Chair Gramm stated his preference to handle the issue of privacy in separate legislation. Some Republicans in the House agreed. For example, Representative Marge Roukema, R-NJ, who chaired the House Financial Institutions Subcommittee, said that any banking privacy provisions would merely "set the stage for more comprehensive privacy legislation."[593]

A Compromise Bill

As Senate and House leaders completed work on the compromise legislation behind closed doors, with a scheduled deadline of 12 October, the White House reissued veto threats on 8 October to pressure the outcome on both community reinvestment and federal regulatory structure. While most bankers were resolved to accept the expansion of the CRA provisions demanded by the Administration, Gramm remained adamantly opposed.[594]

Regarding the operating structure issue, *Congressional Quarterly* reported that Congressional conferees were hoping it would be handled between the Federal Reserve and Treasury. The Federal Reserve's longstanding position was that financial conglomerates must keep their banking, insurance and securities affiliates separate under

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[593] Parks, "Privacy Has Banks on the Defensive," 2054–55.

[594] Gramm, Interview, January 16, 2018; Parks and Nitschke, "Home Stretch at Last," 1675–77. So, the major practical question heading into conference was how far the administration and Gramm were willing to compromise to pass financial modernization? This issue was already being framed as a civil rights matter linked to the Community Reinvestment Act. As a Leadership Conference on Civil Rights news release asked rhetorically, "does the 106th Congress want to become known as the Congress that squelched the American Dream for millions of hard-working Americans?" However, Gramm was unmoved. He was known for taking strong positions and holding to them, as he did to kill financial modernization in the 105th Congress.

a common holding company, which would fall under the Fed's regulatory authority. Treasury, in support of the Office of the Comptroller of the Currency, wanted to preserve the option for organizing the different functions as operating subsidiaries of a parent company, nominally a bank, which would fall under the regulatory authority of the OCC. Rubin's replacement by Summers offered some hope of a breakthrough on the issue. Leach implored the two agencies to come up with an acceptable compromise to avoid a Presidential veto.[595]

Gramm, Leach, and Bliley emerged from behind closed doors to reveal their compromise bill on 12 October, and reconvened the full conference on 14 October to open the draft bill (S. 900) to amendment. The bill demonstrated compromise on three key points: financial privacy, community reinvestment, and unitary thrifts. Regarding consumer privacy, the bill generally followed the House H.R. 10 bill, including "opt-out" provisions and requirements for companies to disclose information sharing policies. The financial industry had previously indicated it would accept these privacy restrictions but no more. A letter sent to each conferee on 13 October stated, "Our associations will support legislation containing the privacy provisions in the print released (12 October). However, our associations will find it necessary to oppose any legislation that…imposes opt-in requirements and/or imposes new restrictions on the sharing of information among affiliates."[596]

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[595] James A. Leach, E-mail to Timothy J. Galpin, November 20, 2017; Daniel J. Parks, "Banking Deal Appears at Hand as White House Reissues Veto Threat," *CQ Weekly*, October 9, 1999, 2374.

[596] Daniel J. Parks, "Compromises Give a Big Boost to Financial Services Rewrite," *CQ Weekly* (October 16, 1999): 2449–51. The industry coalition included the Securities Industry Association, the American Bankers Association, the American Council of Life

While stronger than the previous Senate version of S.900, these privacy provisions were less stringent than those demanded by consumer advocates and the White House. Also, the compromise bill included an exception to the “opt-out” financial privacy requirements for joint marketing activities. This exception was made in support of small banks, who argued that the privacy restrictions would be more burdensome for them than for large banks. The compromise was supported by the conferees even though the reactions by some lawmakers, including Senator Richard C. Shelby, R-AL and Rep Edward J. Markey, D-MA, as well as consumer rights groups such as Ralph Nader’s Public Citizen, Phyllis Schlafly’s Eagle Forum, and the ACLU, were negative. For example, the Senate Banking conferees rejected an “opt-in” amendment (6-14) offered by Sen. Shelby and Senator Richard H. Bryan, D-NV. In arguing against the amendment, Gramm had countered that the information sharing disclosure policy should provide customers all the information they needed to decide whether or not to do business with any given bank.[597]

The second major compromise from the conference was on community reinvestment. This issued faced stronger opposition, including a veto threat. While S.900 as marked preserved the ability of bank regulators to halt mergers or acquisitions if the associated bank did not have satisfactory CRA ratings, it also added two new provisions that were problematic. One was a reduction in the frequency of CRA exams for small and rural banks, which represented a compromise for Graham, who had advocated exempting these banks from CRA entirely. The other was a new “sunshine” requirement intended to

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Insurance, the American Insurance Association, the Financial Services Council and the Investment Company Institute.

[597] Parks, “Compromises Give a Big Boost,” 2449–51.

prevent banks from striking confidential deals with community activist organizations to support deals in exchange for loans or grants by the bank, which Gramm had previously characterized as "blackmail."[598]

Although Democrats postured that these steps set the nation on the path to gutting the CRA, Gramm protested that, "Nothing in our bill undoes CRA." Democrats claimed that the CRA provisions would lead to a veto and community groups undertook a highly visible lobbying campaign against S.900. For example, the Leadership Conference on Civil Rights protested that the reduced inspection frequency would hamper enforcement, and the sunshine provisions would lead to an unnecessary administrative burden. Efforts to strengthen the CRA provisions were highlighted by Reverend Jesse Jackson joining the conference discussions on 15 October, and lobbying by the President of the National Community Reinvestment Coalition, John E. Taylor. Yet despite these pushback efforts the House conferees backed their leaders, rejecting an amendment by Rep. John J. LaFalce that sought to overturn the CRA provisions (12-15).[599]

The least contentious compromise emerging from the Gramm, Leach, Bliley closed door caucus was regarding unitary thrifts. The banking lobbyists and trade associations had made clear that, as in the 105th Congress, they were willing (and probably able) to block a bill that did not close the unitary thrift loophole. As a result, conferees adopted provisions similar to the Senate version of S.900 that prohibited new thrifts after 4 March 1999, and required Federal Reserve approval for the purchase of an existing thrift by a commercial company after that date as well. The compromise with the

[598] Parks, "Compromises Give a Big Boost," 2449–51.
[599] Parks, "Compromises Give a Big Boost," 2449–51.

thrift industry was that existing affiliations between thrifts and insurance companies as well as commercial firms would not be affected.[600]

Final Steps

In a related breakthrough, on 14 October the Federal Reserve Chairman and Treasury Secretary announced a compromise in their previously intransigent positions related to regulatory oversight. After several weeks of the Treasury and Federal Reserve staffs working the issue, it finally took a face to face meeting on 14 October between Chairman Greenspan and Secretary Larry Summers to broker the final deal. As with the Senate and House bills, financial services could be organized under bank holding companies, and most financial services were still expected to be organized as holding company affiliates. The compromise was that many financial services would be allowed in operating subsidiaries to banks, with the important exceptions of insurance underwriting and real estate development. These latter functions would have to be placed in affiliates organized within bank holding companies.[601]

Overall, this was undoubtedly a crucial development for financial modernization legislation because it averted a presidential veto. Both House and Senate Banking Chairs indicated they would support the result if it was acceptable to both the Fed and Treasury. According to AIA spokesman Dan Zielinski, "The resolution of the op-sub issue was a strong indication that a final deal would be struck…after that, the other issues ultimately

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[600] Lori Nitschke and Daniel J. Parks, "Who Wins If Barriers Fall?" *CQ Weekly* (October 23, 1999): 2504–6.

[601] Interview, James Sivon, March 22, 2017, retained by Timothy Galpin; Alan Greenspan, *The Age of Turbulence: Adventures in a New World* (New York, NY: Penguin Press, 2008), 198-200; Parks, "Compromises Give a Big Boost," 2449–51; "A Hard-Fought Victory," *Insurance Advocate* 110, no. 42 (October 23, 1999): 3.

fell into place." This momentum led directly to the breakthroughs on financial privacy, CRA provisions, and FHLB capital standards on 21-22 October.[602]

Unfortunately, the community reinvestment provisions remained problematic. Both sides had hardened their positions after the 12 October compromise bill delivered by Gramm, Leach, and Bliley, as each side declared their position to be grounded in principle. Despite active involvement by Secretary Summers with the conference leaders from 18 October on, Congress and the administration appeared to be at an impasse as late as 21 October. In fact, at one point on 20 October Treasury agreed to a deal, only to see it rejected by the White House. [603]

When the breakthrough finally came on 22 October, the compromise retained the key elements from the 12 October version. That is, satisfactory CRA ratings would be required for all banks to participate in a merger or acquisition, but regulatory exams for small and rural banks were reduced in frequency if prior exams had been satisfactory, and sunshine provisions would expose any loans or grants deal made by bankers to activist groups in order to gain support for bank mergers or acquisitions. The final compromises on the conference bill were brokered in the early hours of 22 October 1999, and announced at 2:00 AM.[604]

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[602] "Eight Amendments to Financial Services Legislation Are Adopted by Conference; Eight Others..." *Insurance Advocate* 110, no. 42 (October 23, 1999): 41. Parks, "Compromises Give a Big Boost," 2449–51; "A Hard-Fought Victory." *Insurance Advocate* 110, no. 42 (October 23, 1999): 3. The Oxley amendment was adopted by House conferees (20-10), and the overall privacy measure was then approved by Senate conferees by voice vote, with the House approving (22-7 with one abstention).

[603] Daniel J. Parks, "Financial Services Bill in the Final Stretch," *CQ Weekly* (October 23, 1999): 2498–2503; "A Digest of Provisions," *Insurance Advocate* 110, no. 43 (October 30, 1999): 3.

[604] Parks, "Financial Services Bill in the Final Stretch," 2498–2503; "A Digest of Provisions," 3.

At this point the White House was prepared to accept that it had wrung all the concessions it would get out of the process. Senate Democrats praised the early morning compromise, as did the administration. Treasury Secretary Lawrence H. Summers, said in a handwritten statement that while "nothing is done until the final language is fully reviewed, significant improvements" were made to the community reinvestment provisions, which were the last remaining hurdle. Summers noted the final conference language met all of President Clinton's goals. He concluded that, "The Administration strongly supports S. 900, and urges its adoption by the Congress."[605]

There was of course some remaining opposition. Ranking member of the House Commerce Committee, John Dingell, for example, cried, "The flimsy limitations and firewalls here will not hold back the contagion and misfortune that follow the foolishness in not reforming deposit insurance, thus creating enormous risk to taxpayers and depositors."[606] In the end, however, both houses adopted the measure on 4 November 1999 with strong bipartisan support. The House vote to adopt the conference report for S.900 was 362-57 and the Senate vote was 90-8.[607] President Clinton signed the Gramm-

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[605] Lawrence H. Summers, "Letter to Congressional Leadership with the Clinton Administration Support for S.900," Treasury of the United States (November 1, 1999): 3. Courtesy of the William J. Clinton Presidential Library & Museum; Parks, "Final Stretch," 2498–2503. Summers did caveat some concerns about redomestication (moving to another state) of insurance companies and extension of FHLB loans to community banks.

[606] John D. Dingell, "Letter from Democrat Congressional Leadership Requesting That Clinton Veto S.900," Congress of the United States (October 25, 1999). Courtesy of the William J. Clinton Presidential Library & Museum; Don Ogilvie, *ABA Banking Journal* 91, No.12 (December 1999): 8-12. While Dingell and 25 others asked the President to veto the bill, they were in a clear minority.

[607] *Gramm-Leach-Bliley Act: Conference Report (to Accompany S. 900),* Report / 106th Congress, 1st Session, House of Representatives: 106-434, Washington, D.C.: U.S. G.P.O., 1999.

Leach-Bliley Act, also known as the Financial Modernization Act of 1999 (PL 106-102), on 12 November 1999.[608]

Gramm Leach Bliley: Major Compromises and Policy Results

GLBA repealed two of four key sections of the 1933 Glass-Steagall Act, which separated commercial and investment banking, as well as the Bank Holding Company Act of 1956 (as amended), that separated commercial banking and insurance.[609] In addition to permitting the affiliation of banking, securities and insurance firms, it provided a codified regulatory framework for the financial services industry.[610]

GLBA meant to first order that banks, securities, and insurance firms could affiliate in a holding company structure as of 11 March 2000. The law enumerated a lengthy list of activities that were considered "financial in nature" and therefore authorized to bank holding companies, to then be known as financial holding companies. This expanded list of what should be considered "financial in nature" had been a feature of financial modernization for years, and was by this point uncontroversial. Even more empowering for the new financial institutions, assuming one was well capitalized, well managed, and received a "satisfactory" or better CRA rating on its last exam it would be

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[608] William Jefferson Clinton, "Remarks on Signing the Gramm-Leach-Bliley Act," The American Presidency Project, November 12, 1999.

[609] The Banking Act of 1933, Pub. L. No. 33-66, Ch. 89, §16, 20, 21, 32, 48 Stat. 162, 184, 188, 189 (1933), (codified as amended 12 USC§24, 78, 377, 378 (1988)). What is known as the Glass Steagall Act (GSA) is actually 4 sections of the Banking Act of 1933. Sections 16 and 21 were retained. Sections 20 and 32 were repealed. Section 20 prohibits commercial bank affiliation with any organization "engaged principally" in the securities business, while Section 32 prohibits commercial bank officers, directors, staff from serving in those capacities at another firm "principally engaged" in securities.

[610] Daniel J. Parks and Chuck Conlon, "Financial Services Overhaul," *CQ Weekly* (November 20, 1999): 2797–2801; Gramm Leach Bliley Act. "Text - S.900 - 106th Congress (1999-2000): Gramm-Leach-Bliley Act | Congress.Gov | Library of Congress," accessed July 7, 2017. https://www.congress.gov/bill/106th-congress/senate-bill/900/text?overview=closed.

able to begin listed financial activities without prior approval. A simple notification to the Board was required within 30 days of commencing the activity.[611]

While the Federal Reserve was designated as the umbrella regulator for financial holding companies, Congress formulated a policy of functional regulation within GLBA. This compromise eliminated much of the opposition to the law by regulatory agencies since in effect it meant that similar activities would be regulated by the same agency regardless of the nature of the institution. In other words, national banks would still be regulated by the Comptroller, FDIC, or state regulator as appropriate. Insurance and securities activities would be overseen by their respective state and federal regulators, even if conducted by a bank subsidiary or affiliate. This approach meant that insurance activities in banks would be regulated by state commissioners, and new bank securities activities by the SEC or state securities regulator.[612]

In order to make the functional regulation approach work, a series of specific exceptions were imposed. One insurance caveat was that states were enjoined from discriminating in favor of insurance agencies in regulating the insurance activities of banks. Specifically, states were not allowed to "prevent or significantly interfere" with the insurance activities of a national or state bank. Additionally, Council of Insurance Agents and Brokers (CIAB) President Ken A. Crerar highlighted one provision of the bill that is unique to the insurance industry. Under the National Association of Registered Agents and Brokers (NARAB) provision, once passed the new federal law states would require states to pass reciprocal licensing statutes. Crerar pointed out that, "If a majority

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[611] James D. McLaughlin, "There's More to 'Financial' than Meets the Eye," *ABA Banking Journal* 91, No. 12 (December 1999): 12-14.

[612] McLaughlin, "There's More to 'Financial' than Meets the Eye,"12-14; Abernathy, Interview, January 23, 2018.

of states fail to do so within three years, NARAB will be created as a multi-state licensing clearinghouse through which agents and brokers may apply for membership." It was explicitly left to the NAIC, fulfilling the associational role as it had so many times before, to coordinate and implement this reciprocal licensing provision.[613]

Similarly, banks were authorized the full range of securities activities, with new securities activities subject to SEC oversight. However, GLBA included a series of specific exemptions of traditional bank activities from SEC oversight. Since trust services were exempted from SEC oversight, the law included provisions to prevent brokers from evading SEC oversight through trust services in banks. The general exemption for banks fiduciary activities was also conditioned by a requirement that security trades be routed through registered brokers, which were regulated by the SEC. The quid pro quo for broker-dealers was authorization to form holding companies with affiliated wholesale financial institutions (WFI). These "woofies" were not banks, but they were authorized access to the federal payment system, which leveled the playing field for the investment banks.[614]

Another major compromise in the law was the way in which it dealt with the affiliate versus operating subsidiary issue. The Congress accepted a last-minute deal between Board Chairman Alan Greenspan and Treasury Secretary Rubin's successor, Larry Summers, to preserve the holding company structure. The Treasury's Office of the Comptroller of the Currency would generally oversee banks and their subsidiaries that

[613] "Producers' Association Uniformly Support Enactment of Financial Service Reform Act," *Insurance Advocate* 110, no. 43 (October 30, 1999): 4.

[614] Abernathy, Interview, January 23, 2018; McLaughlin, "There's More to 'Financial' than Meets the Eye," 12-14. The law contained a "de minimis" exception for up to 500 trades of securities per year.

were not part of a holding company. Bank subsidiaries were authorized to engage in any activity that was permitted to the bank itself. The major caveat to this compromise was that the total assets of a bank's subsidiaries could not exceed $50 billion, or 45% of a bank's assets, whichever was less. If total assets were more than $50 billion, these activities would have to be organized as affiliates in a financial holding company structure.[615]

As a practical matter, the compromise on organizational structure was a victory for Greenspan. Despite allowing operating subsidiaries, there was a strong incentive to organize around a holding company structure because bank subsidiaries were prohibited from insurance underwriting, real estate development, merchant banking, and insurance company portfolio investments. If banks sought to affiliate with insurance underwriters or real estate developers, they could only do so in a holding company structure. These financial holding companies would remain under the supervision of the Federal Reserve, along with traditional bank holding companies.[616]

The unitary thrift loophole, much like the nonbank bank loophole before it, existed for years in the law before being put into widespread use. It carried the potential to breech the historical barriers between commercial firms and banking, and once discovered was wielded as an effective weapon by the large insurance companies to

[615] Abernathy, Interview, January 23, 2018; Steven Brostoff, "Industry Favors New Financial Services Modernization Plan," *National Underwriter / Life & Health Financial Services* 103, no. 42 (October 18, 1999): 1, 49; McLaughlin, "There's More to 'Financial' than Meets the Eye,"12-14. In this context, merchant banking is the practice of taking an equity position in an acquired or merged company with the intent of reselling it. GLBA contained a provision that Treasury and the Board could jointly develop rules that loosened the merchant banking restrictions after five years.

[616] Steven Brostoff, "Industry Favors New Financial Services Modernization Plan," *National Underwriter / Life & Health Financial Services* 103, no. 42 (October 18, 1999): 1, 49; McLaughlin, "There's More to 'Financial' than Meets the Eye,"12-14.

battle back against the encroachment by banks into insurance. Although GLBA closed the loophole as of 4 May 1999, existing unitary thrift holding companies were "grandfathered" in to allow continued operation. Winners included the large insurance companies that were approved or in the pipeline before 4 May. Losers most notably included Walmart, which applied in July.[617]

The community reinvestment provisions required any financial institution to have a "satisfactory" or better CRA rating to obtain approval for expansion. The compromise to Senator Gramm's demands was a new "sunshine" requirement that any agreement and payment between a bank or bank affiliate and a community organization regarding CRA must be reported by both the financial institution and the community activist to the bank's federal oversight agency. Gramm's sunshine provision sought to curb what he viewed as shakedowns of the banks by community activist organizations. The recipient was required to provide a detailed accounting of the uses of the funds. If recipients failed to comply, the regulator could force them to return the funds and bar them from further participation in CRA matters for up to ten years. Other CRA measures won by Gramm included relief for small banks (with less than $250M in assets), such that they only need be subject to a CRA examination every four to five years, depending on their previous grade.[618]

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[617] "Special Report," *ABA Banking Journal* 91, No.12 (December 1999): 12-28. The deadline was purposefully selected to prevent Walmart from completing the purchase of an Oklahoma thrift. While many commercial companies had purchased thrifts in the years leading up to GLBA, Walmart struck a particular chord in the hearts of small bankers given its record of out-competing small businesses throughout rural America. Senator Gramm said at a S. 900 conference hearing on 21 October, "Wal-Mart will be doing banking within a month if this bill is vetoed."

[618] Don Ogilvie, *ABA Banking Journal* 91, No.12 (December 1999): 8-12; "Special Report," *ABA Banking Journal,* 12-28. Even after the law was signed, some community

The privacy provisions in GLBA were another last hour addition relatively speaking. Since these rules were forced into the law by Congressional Democrats and the Clinton Administration in final negotiations, there was little time to debate and come to a comprehensive public policy. The financial trade associations lobbied hard to prevent the addition of another layer of regulation, and ultimately the responsibility for ensuring customer privacy was assigned to the functional regulators. Also, while specific "opt-out" requirements were included, these were thought by the industry to be far preferable to requiring customers to "opt-in" to information sharing among affiliates. The latter was considered unaffordable at best and in all likelihood unworkable. Additionally, the opt-out provisions were restricted to third parties; they did not affect affiliates or subsidiaries.[619]

Finally, one less well publicized feature of GLBA was a significant expansion in access by community banks to the FHLB System. Although commercial banks were allowed to join the system as of 1989, regulatory impediments made use of the system problematic. Formerly, community banks could only use mortgage loan portfolios as collateral for loans from the FHLB system. GLBA expanded access by allowing use of small business and farm loans as collateral as well. The reforms had the primary effect of

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activists continued to deplore the CRA provisions. And Maxine Waters, member of the House Banking Committee, disclaimed: "What I am surprised about is the mean-spirited way in which we have undermined the Community Reinvestment Act. There was no need to have CRA on the table except for one person (Senator Gramm), who does not like CRA, came into the conference committee, determined that he was going to weaken it and he did."

[619] John Byrne, "What is--and What Could Have Been," *ABA Banking Journal* 91, No. 12 (December 1999): 17. Although not a privacy provision per se, the law included notification requirements for ATM fees to resolve long-standing complaints of abuse.

increasing the availability and reducing the cost of funds to community banks during localized downturns, such as recessions or crop failures.[620]

Chapter 4 Conclusion: Passing GLBA in the 106th Congress

The Gramm Leach Bliley Act (GLBA) of 1999 repealed the Glass-Steagall regulatory framework in order to allow the affiliation of commercial banking, securities, and insurance. While there was some interest in broader reform, this chapter identifies and explains the factors that caused GLBA to focus primarily on repealing Glass-Steagall to the exclusion of other aspects of financial modernization. In part, GLBA was simply constrained by the art of politics and the compromises necessary to pass complex and economically significant legislation. Yet equally GLBA was a product of its times, as several long-term trends shaped the perspectives of leading policymakers.

In many ways, the effort to pass GLBA was a classic legislative campaign at the nexus of three streams: problems, policies, and politics.[621] The policy goal was the repeal of specific aspects of the Glass-Steagall and Bank Holding Company Acts. Financial services industries with deep pockets sought legislation in support of their sometimes

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[620] Joseph Pigg, "An End to Funding Volatility?" *ABA Banking Journal* 91, No.12 (December 1999): 16-17. For banks with less than $500 million in assets, agricultural and small business loans became eligible collateral for FHLBA access in addition to mortgages. In other words, those banks no longer had to meet the 10% whole mortgage test to join the system, which enabled an additional 2,600 banks to join. *ABA Banking Journal* reported the change in collateral rules meant an increase in lendable funds to these eligible banks by a factor three to five times the previous amount. Finally, a procedural requirement known as the Qualified Thrift Lender (QTL) test was removed. Originally intended to ensure thrifts were sufficiently engaged in mortgage lending, the test had become obsolete, while also putting banks at a disadvantage to thrifts. Ches Brooks, CEO of Omnibank in Houston, explained the practical effect was that "commercial banks had to buy as much as four times the amount of stock to borrow the same amounts as our thrift competitors." Under GLBA, thrifts still have to meet the QTL test to maintain their charter, but no institution would be subject to the test for borrowing from the system.

[621] Kingdon, *Agendas, Alternatives, and Public Policies,* 15-20.

conflicting interests. The regulatory state had been actively been working towards the policy goal within their authorities, enabled by the courts, and encouraged Congress to validate their actions. The policy window opened with the arrival of the right set of congressional leaders, the resolution of several distracting issue in the 105th Congress, an impetus from the Citigroup merger, and the closing of the Clinton impeachment trial.[622] And, finally, several sets of policy entrepreneurs found ways to leverage the process through politics, not least President Clinton and his financial privacy initiative.

However, when considered in the context of policy development through time, GLBA also represented the culmination of several long-term trends in financial regulation. In particular, the functional regulatory compromise was necessary in order to gain a consensus from both industry and the regulatory community to pass the law. Unfortunately, given the relationships among the regulators and their respective industries this also resulted in a regulatory structure that was fundamentally unchanged from the status quo. Additionally, a changing ideological consensus encouraged self-regulation while policymakers remained overly focused on defining market risk and safety through the lens of Depression-era financial structures such as federal deposit insurance.

What GLBA did not do in a broader sense is provide any additional safety and soundness regulation, or any specific legislative approach to new financial markets, institutions, or products that may have presented a greater threat now that the law permitted the formation of large systemically important institutions. One such issue, the impact of a bias towards free market regulation and market discipline, become apparent

[622] Leach for example was term limited as Chair of the House Banking Committee, and felt great pressure to bring financial modernization to closure.

in the parallel debate over renewal of the Commodity Exchange Act and the Commodity Futures Trade Commission, which will be discussed in terms of policy development over time in the next chapter.

Chapter 5: Reform Beyond Repeal of Glass Steagall

The financial policy community returned to the broader issue of financial services modernization during second session of the 106th Congress in 2000. Despite clear evidence from market failures such as the hedge fund Long-Term Capital Management (LTCM), the regulatory approach taken by Congress failed to reduce the systemic risk to the U.S. financial system from relatively new instruments and markets, including hedge funds and over-the-counter (OTC) derivatives. Given the role played later by these innovations in the 2008 financial crisis, it is important to understand how and why Congress declined to incorporate into either of the two major financial modernization laws it passed -- the Gramm Leach Bliley Act of 1999 (GLBA) or the Commodity Futures Modernization Act of 2000 (CFMA) -- the safety and soundness controls necessary to protect financial markets. This chapter explains how consideration of known concerns with OTC derivatives was deferred from GLBA and why potentially effective regulatory policies were either deliberately omitted or left to self-regulation in CFMA.

Reformers in the 106th Congress and the Clinton Administration ultimately decided to separate the deregulation of commercial banking, securities, and insurance from the regulation of OTC derivatives for several institutional and structural reasons. To begin with, the debate was constrained by the path dependence of previous efforts to reform and update Depression-era regulatory institutions and laws. In particular, the Congressional debate about regulating OTC derivatives took place in the context of parallel efforts to repeal the Glass-Steagall Act of 1933 and to update the Commodity Exchange Act (CEA) of 1936, which was being reconsidered as part of a periodic review of the Commodity Futures Trade Commission (CFTC) charter. Additionally, the Federal

Reserve, OCC, SEC, and CFTC all disputed jurisdiction and regulatory approaches to OTC derivatives. For example, key policymakers such as Federal Reserve Chair Alan Greenspan, SEC Chair Arthur Levitt, and Treasury Secretary Robert Rubin held that OTC financial derivatives were not subject to the authority of the CFTC because they were transacted directly between banks and securities brokers, and not on either a commodity or futures exchange. CFTC Chair Brooksley Born, on the other hand, argued for classifying the OTC derivatives market as a futures exchange subject to CFTC oversight.[623]

In addition to disputes among regulatory agencies, Congressional jurisdiction was not aligned with the way in which the derivative markets had developed. While Glass-Steagall repeal was being considered by the Banking and Commerce Committees, primary jurisdiction for futures and derivatives historically had been assigned to the Agriculture Committees, which were also leads for the renewal of the CEA. Congressional leaders such as Leach and Gramm argued that adding another sequential jurisdiction to financial modernization would create unnecessary complexity, especially since they had already decided to concentrate banking reform on repeal of Glass-Steagall. Finally, concern over the bailout of LCTM led Congress to direct the President's Working Group on Financial Matters (Working Group) to study the regulation of OTC derivatives. At the request of the Working Group, Congress deliberately pushed the timing of those reports beyond the scope of the efforts to repeal Glass-Steagall.[624]

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[623] Mark Jickling, "CRS Report: RS20560 - Derivatives Regulation: Legislation in the 106th Congress," October 10, 2000, 1-2.

[624] The President's Working Group on Financial Markets was created by Executive Order 12631 on 18 March 1988, by President Reagan. Its members consisted of the Secretary of the Treasury, the Chair of the Board of Governors of the Federal Reserve,

When Congress deferred the issue to the CFMA, which served to modernize the Commodity Exchange Act and renew the CFTC charter, this did not resolve the debate over regulating OTC derivatives. Even though the CFMA became the legislative vehicle used to update the regulation of OTC derivatives, two other trends led Congress and the Administration to deliberately omit the requirement for certain safety and soundness features from the legislation. To begin with, the growing complexity of the financial markets became a factor. Congressional leaders and federal regulators generally lacked the expertise to understand the technologies that underpinned many of the market innovations in securitization and electronic trading. This caused them to misunderstand the nature of the systemic risk that OTC derivative transactions could present to financial markets as a whole. Additionally, the changing ideological consensus towards a free-market bias, with a primary focus on improving the competitiveness of U.S. financial markets, shaped a preference for market self-discipline over market regulation. As a result of this shift, key regulators and Congressional leaders decided to rely on the financial institutions themselves to mitigate their own transactional risks in the OTC derivatives markets.

While GLBA and CFMA were the two pillars of financial modernization reform in the 106th Congress, even taken together they failed to provide adequate safety and soundness protection for the new financial products, institutions, and markets that were incorporated into the modern financial system. The collapse of the hedge fund LTCM provided more than ample warning that the use of OTC derivatives by a small number of large counterparties could put the entire financial system at risk. Indeed, the Working

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the Chair of the Securities and Exchange Commission, and the Chair of the Commodities Futures Trading Commission.

Group identified several functions that could be regulated at the market level, including the netting and close-out of transactions on a routine basis, which could have provided adequate safety and soundness for the OTC derivatives market. Unfortunately for the future stability of financial markets, Congress wrote the CFMA to merely allow but not require their use. This deliberate omission represented perhaps the greatest failure of the financial modernization efforts in the 106th Congress.

The Origins of the Derivatives Market and Commodity Exchange Act

Efforts to establish regulatory policies for the OTC derivatives market were impeded by an evolving and complex market environment, vague legislative history, as well as multiple jurisdictions both among regulatory agencies and in Congress. In the absence of Congressional action to regulate derivatives, the financial industry and regulatory community were left to balance market innovation with safety and soundness. This section describes the factors that inhibited Congress and the federal regulatory agencies from acting together to resolve the policy disputes about hedge funds and the OTC derivatives market that emerged in the 1990s.

Complex Market Environment Outpaced Regulation

One reason that new comprehensive legislation was necessary to modernize the regulation of derivatives was that the evolving OTC market was growing both in complexity and in volume. The systemic importance of derivatives significantly raised the stakes in terms of regulatory approaches. As analyst Robert Hogue stated, “There's a new market with new products. It's a rapidly growing market. Whoever controls it is going to win big."[625]

Derivatives were an important modern innovation in risk reduction for financial transactions. Because they are often today associated with the financial crisis of 2008, it is easy to overlook the revolution in corporate and governmental financial risk management that OTC derivatives provided at the time. Similar to but different than commodity options and futures, derivatives were financial contracts the value of which was dependent or derived from some underlying asset. These assets could be equities, bonds, commodities, interest rates, exchange rates, or even an artificial index or specific group of assets. Although the original value of derivative contracts was the ability to mitigate risks, the market later evolved to trade the derivatives as securities for profit.[626]

Participants in derivatives activities are either end users or dealers. Typical end users are corporations, governmental entities, institutional investors, and financial institutions. Dealers are commonly commercial banks and securities firms along with a few insurance firms and some energy-related businesses. Derivatives are "over-the-counter" (OTC) when they are made between counterparties through a private transaction without benefit of a publicly regulated exchange. OTC derivatives permit end users and dealers to hedge or manage risks by establishing a known relationship among combinations of cash flow, interest rate, currency, liquidity and market source characteristics. Although most early derivative transactions were hosted by banks acting

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[625] Robert D. Hogue, "Securitization--Convergence Between Financial and Insurance Products Is Emerging," *Insurance Advocate* 110, no. 10 (March 6, 1999): 32.

[626] "Group of Thirty Global Derivatives Study (July 1993)," in Lissa L. Broome and Jerry W. Markham, *Regulation of Bank Financial Service Activities: Cases and Materials*. 3rd ed. American Casebook Series (St. Paul, MN: Thomson/West, 2008): 808-822.

as dealers in their traditional role as financial intermediaries, insurance companies and broker dealers quickly caught on to the lucrative market and began to establish their own subsidiaries to serve as derivative dealers as well.[627]

In its simplest form, a derivative is a contract between two parties. For example, a company that has borrowed at variable rates of interest might seek to mitigate the risk of an interest rate increase in the future by exchanging those payments with a company that has a loan against a fixed rate of interest. The company on the fixed side of the trade might choose to enter into it on the expectation that interest rates would go down. As the OTC derivative market evolved, such bilateral trades, known as swaps, were formalized under common terms and hosted by commercial banks or security dealers as securities. This allowed an end-user company to simply buy such a swap directly from the broker-dealer. For example, a company negotiating an international commercial transaction could protect itself from the risk of unfavorable exchange rate movements by purchasing a derivative based on the expected future values of the respective domestic and international currencies.[628]

At face value, derivatives provided a mechanism to significantly reduce the risk of individual transactions. However, by the late 1990s, two issues had developed with derivatives that threatened to destabilize the broader financial markets. The first was that hedge funds, a new type of financial institution that made use of derivatives for risk

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[627] Alan Greenspan, "Regulation of Over the Counter Derivatives," Testimony presented at the Committee on Banking and Financial Services, U.S. House of Representatives, Washington, DC (July 24, 1998): 3.

[628] James A. Leach, "Derivative Regulation," Congressional Record, Volume 140 Issue 2, (January 26, 1994), 1-12. See also James A. Leach, "Risk Management Improvement and Derivatives Oversight Act," U.S. House of Representatives, January 4, 1995.

reduction, began to trade derivatives as securities. At first, the financial community learned to leverage the securitization of derivatives to lower the cost of funds for productive social uses such as consumer credit, student loans, and home mortgages. At the same time, derivatives nominally could be used to reduce taxpayer exposure at government sponsored enterprises (GSE) such as Fannie Mae and Freddie Mac.[629] As securitization evolved, the process eventually led to derivative securities becoming divorced from the value of their underlying assets. Other dealers and end-users beyond hedge funds noted how profitable this practice was and they followed suit.[630]

The second major destabilizing factor was that both broker-dealers and end users of the derivative contracts demonstrated a marked preference for OTC over more highly regulated exchange-based transactions. Obviously, the counterparties believed that they could underwrite more profitable derivatives transactions in the unregulated OTC markets. For example, a bank leveraging a privately negotiated swap might not have to retain capital reserves to cover the market risk, whereas market regulators would require such reserves for an exchange traded swap. Yet from a public policy perspective, the growth of the OTC derivatives market led to an unsustainable position wherein securities with trillions of dollars' worth of face value were traded in unregulated private transactions.[631]

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[629] Although the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Association (Freddie Mac) are among the better known GSEs, others include the Federal Home Loan Banks, the Federal Agriculture Mortgage Corporation (Farmer Mac), and Student Loan Marketing Association (Sallie Mae).

[630] Leach, "Derivative Regulation," 1-12.

[631] Robert D. Hogue, "Securitization--Convergence Between Financial and Insurance Products Is Emerging," *Insurance Advocate* 110, no. 10 (March 6, 1999): 32.

In terms of size, as a snapshot, the underlying value of goods and services in the OTC markets reached $70 trillion worldwide by June 1998. While the OTC market was growing exponentially with the addition of new types of contracts, at this point approximately 67% of the derivatives were interest rate, 30% exchange rate, and the rest based in equities or commodity transactions. And the growth rate was accelerating, with an increase of 24% in swaps in the first half of 1998 alone. In other words, the sheer size of the burgeoning derivatives market made it significant. As Richard Lindsey, the SEC Director of Market Regulation, noted, “It is clear that events in the OTC derivatives market can impact the capital markets as well.” Unfortunately, as the financial markets evolved, neither legislation nor regulatory controls had kept pace.[632]

The Failure to Anticipate OTC Derivatives in Legislation

Over-the-counter (OTC) derivatives transactions were not considered in the Depression-era legislation to regulate banks, securities, commodities, or futures markets. Later efforts to leverage the Commodity Exchange Act by tying derivatives to commodity futures for regulatory purposes fell short because there were vested interests in the banking and securities industries that preferred to retain control of the oversight of the derivatives markets. However, Congressional efforts to define derivatives as securities separate from futures contracts also failed to resolve the regulatory disputes. In the end, all of these piecemeal legislative efforts at reforming financial regulation to accommodate innovations in the OTC derivatives market were ineffective.

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[632] Bank of International Settlements, “The Global OTC Derivatives Market at end June-1998,” Press Release; Richard R. Lindsey, “SEC Testimony: OTC Derivatives in the U.S. Financial Markets,” Testimony Concerning presented at the Senate Committee on Agriculture, Nutrition, and Forestry, Washington, D.C. (December 16, 1998): 1-2.

From a policy perspective the commodity markets were regulated similarly to the securities markets and for much the same reason. The Securities Act of 1933 was driven largely by the Pecora Commission, which found that the securities markets were subject to fraudulent stock and bond sales, insider trading, and price manipulations. Several years later the Commodity Exchange Act of 1936 (CEA) was established in the wake of commodity market failures attributed to fraud and grain market manipulation.[633] The original CEA was a modification of the Futures Trading Act of 1921 designed to broaden the Secretary of Agriculture's oversight of future exchanges.[634] The CEA was amended periodically, notably in the Commodity Futures Trading Commission (CFTC) Act of 1974, which created the CFTC and transferred to it the Secretary of Agriculture's authority over commodities markets. Similarly, the Futures Trading Act of 1978 amended the CEA to assign the authority for futures exchanges to the Chairman of the CFTC.[635]

The commodities and futures trading markets had complex interrelationships with other financial markets even before derivatives became a significant financial force. Not surprisingly, the overlapping nature of the markets was sometimes a source of significant dispute among the respective regulatory agencies. For example, the CFTC was created to

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[633] J. M. Mehl, "Objectives of Federal Regulation of the Commodity Exchanges," *Journal of Farm Economics* 19, no. 1 (February 1937): 313 cites ten cases of commodities markets manipulation that were not prosecutable under the law prior to the CEA. See also Alan Greenblatt, "Finance: Open Outcry: Commodity Traders Seek Regulatory Relief," *CQ Weekly* (May 15, 1999): 1131–33; CFA Institute, "Self-Regulation in Today's Securities Markets: Outdated System or Work in Progress?" (2007): vi; Norman S. Poser, "The Origins of the Securities Laws," *Institutional Investor Advocate* (Fourth Quarter 2004).

[634] 42 Stat. 187. See Appendix 5 for key laws in the New Deal regulatory framework.

[635] 88 Stat. 1389; 92 Stat. 865; Lissa L. Broome and Jerry W. Markham, *Regulation of Bank Financial Service Activities: Cases and Materials*. 3rd ed. American Casebook Series (St. Paul, MN: Thomson/West, 2008): 801-801.

regulate the expansion of futures markets beyond physical commodities (e.g., grain, sugar, coffee). At the same time, Congress blocked the CFTC from regulating most transactions concerning government securities and foreign currency. Dubbed the "Treasury Amendment," because it was implemented at the request of the Treasury Department, this restriction was intended to prevent CFTC interference with the oversight of currency trading among banks and other financial intermediaries, which was the purview of the federal bank examiners and the SEC.[636]

The Treasury Amendment created precedence for later disputes between the CFTC and the SEC, Federal Reserve, and Treasury because of ambiguities in the language. Specifically, it held as follows:

> Nothing in this chapter shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgage and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.[637]

Yet the key phrases "future delivery" and "board of trade" remained undefined in the law, presumably because Congress viewed the meaning to be self-evident in the context of commodities trading. This wording became problematic as financial markets and products evolved.[638]

In particular, Congress left open the dispute introduced by the Treasury Amendment over what constituted an "exchange" for purposes of assigning regulatory authority over a transaction between the SEC and CFTC. This was less of a concern in the 1970s and 1980s when derivatives trades were restricted to over-the-counter

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[636] Greenblatt, "Finance: Open Outcry,"1131–33. This provision was known as the "Treasury Amendment."

[637] 88 Stat. 1395, 7 USC § 2(ii)

[638] Jickling, "CRS Report: RS20560," 1-2.

transactions between individual counterparties. However, by the 1990s, as contractual terms for derivatives became standardized and electronic transactions more common, even derivative trades between private counterparties began to more closely resemble those on exchanges, which the CFTC was otherwise authorized to regulate.[639]

Finally, Congress failed to anticipate, and the Treasury Amendment explicitly did not address, the rapid development and growth of a particular type of OTC derivatives; namely, swaps based on interest rates, foreign exchange rates, or securities prices. Originally designed to mitigate transactional risk, these swaps became the underlying basis of a massive new type of security that was traded separately from but interrelated with traditional financial markets.[640]

Fractured Congressional Jurisdictions

The fact that different financial industries and their regulators were subject to different Congressional oversight committees provided an additional complication in terms of comprehensive financial regulatory reform. While banking primarily had its own committees in the House and Senate, and the House Commerce Committee had parallel responsibility for securities and insurance, the CFTC and commodities markets were primarily overseen by the House and Senate Agriculture Committees. Under this structure, oversight authority for both futures and derivatives markets was ceded to the agriculture committees in both the House and Senate.[641]

Even though the agriculture committees had primary oversight over derivatives, the other financial oversight committees periodically took an interest. For example, as discussed in Chapter 3, Representative Jim Leach was a long-tenured member of the

[639] Greenspan, "Regulation of Over the Counter Derivatives,"1-10.
[640] Greenspan, "Regulation of Over the Counter Derivatives," 3.
[641] Abernathy, Interview, January 23, 2018; Natter, Interview, February 22, 2017.

banking committee, and had developed himself into an expert on financial matters dealing with banking. This included the threats from foreign competition as well as from new products, such as derivatives. Indeed, Leach voiced concerns about the regulation of derivatives as early as 1993, when as ranking member of the House Banking, Finance, and Urban Affairs Committee he commissioned a report to detail recommendations for the regulation of derivatives.[642]

Unfortunately, as later remarks by Representative Thomas Ewing, R-IL and Senator Peter Fitzgerald, R-IL made clear, the House and Senate Agriculture Committees remained firmly focused on the Chicago commodities and futures trading communities rather than financial derivatives.[643] This attitude spilled over to the regulatory arena as under the jurisdiction of the agriculture committees the CFTC remained focused on commodities and agricultural futures contracts until later in the 1990s.[644] Thus as a member of the House Banking Committee rather than the Agriculture Committee, and in the minority at that, Leach had little power to see his preferred policy recommendations enacted. Leach later observed that, despite the issues he raised at the time, the indifference of the Agriculture Committees to his proposed legislation on derivatives represented an early missed opportunity to rationalize the emerging OTC derivatives market with other financial services regulations.[645]

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[642] United States House Committee on Banking, Finance, and Urban Affairs, "Safety and Soundness Issues Related to Bank Derivatives Activities: Hearing Before the House Committee on Banking, Finance, and Urban Affairs, One Hundred Third Congress, First Session," Washington: U.S.GPO, 1994.

[643] Thomas W. Ewing, "The Commodity Futures Modernization Act," *Congressional Record* (December 14, 2000): E2181-2182; Peter Fitzgerald, "Remarks in Support of CFMA," Congressional Record (December 15, 2000): S11878-9.

[644] James A. Leach, Working Papers (2009/2010): 6-7.

[645] Leach, E-mail to Timothy J. Galpin, November 20, 2017.

Hence, the jurisdictional dispute between congressional committees was a key factor in the decision to preserve the separation of OTC derivatives regulation from the regulation of banking and securities. As Wayne Abernathy put it, “Even though banks, securities firms, and insurance companies made use of OTC derivatives, oversight was in the Agriculture Committees. There was no appetite to increase the complexity of the negotiations, which in the House already included two committees of jurisdiction anyway.”[646] Consequently, the disputed jurisdiction over derivatives also contributed to the failure to enact comprehensive, or at least coordinated, financial reform legislation.

OTC Derivative Regulatory Reform Efforts in the Early 1990s

The rapid growth in both the size and complexity of the OTC derivatives market through the early 1990s led the financial policy community to consider the question of how derivatives should be regulated in order to minimize systemic market risks. The financial services industries actively promoted a policy of deferring action, and the policy community acquiesced at least in part from a lack of consensus on what steps to take. As a result, those advocating for the competitiveness of U.S. markets were able to defer the actions of those who sought to ensure the safety and soundness of those markets. That is, despite the results of several studies that demonstrated the likelihood such risks could be significant, policymakers elected not to impose regulatory controls in order to allow time for innovative derivatives products, institutions, and markets to develop.

Influential Studies and Reports

Participants in the OTC derivatives market recognized that the use of leveraged and securitized instruments had risks that needed to be managed. The fundamental dispute was about the degree to which risk management would be done by either the

[646] Abernathy, Interview, January 23, 2018; Natter, Interview, February 22, 2017.

market or by government regulation. In 1993, the Group of Thirty, a cross-section of current and former central bankers, leading private sector bankers, influential financial professionals, and renowned academics, commissioned a working group to conduct an authoritative review of industry practices and performance. Paul Volcker, the Chair of the Group of Thirty at the time, freely admitted that the resulting "Global Derivatives Study" was intended to identify ways to ensure effective and efficient market operation in order to stave off government oversight of the innovative and profitable OTC derivatives market.[647]

Although well regarded, the Group of Thirty recommendations were not widely implemented. The SEC's Richard Lindsey later observed that had the internal controls identified by this study been in place several financial failures associated with derivatives could have been avoided, including the Orange County bankruptcy, Wisconsin Investment Board losses, and several corporate failures. Even so, from the SEC staff's perspective the lesson here was not that the OTC markets and derivatives required government regulation; rather it was that institutions leveraging derivatives needed effective self-regulation.[648]

Following the Group of Thirty study, Congress became concerned that the regulatory community's knowledge and professional expertise regarding how to manage and oversee the risks to financial markets associated with derivatives may not have kept pace with their increased use. The Chairmen and Ranking Members of the House and Senate Agriculture, Banking, and (in the case of the House) Commerce Committees

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[647] Paul Volcker, "Introduction to "Derivatives: Practice and Principles," Global Derivatives Study Group, Group of Thirty (July, 1993): 1-2.

[648] Lindsey, "OTC Derivatives in the U.S. Financial Markets,"1-2.

jointly requested that the U.S. General Accounting Office (GAO) consider ways in which the regulation of derivatives could prevent or mitigate future financial crises. They specifically tasked the GAO to determine: (1) what risks derivatives might pose to individual firms and to the financial system and how firms and regulators were attempting to control these risks; (2) whether gaps and inconsistencies existed in U.S. regulation of derivatives; (3) whether existing accounting rules resulted in financial reports that provided market participants and investors adequate information about firms' use of derivatives; and (4) what the implications of the international use of derivatives were for U.S. regulation.[649]

As we will see, both industry and federal regulators opposed the GAO's recommendations even though the GAO report set out a strong case for additional governmental regulation. Specifically, the report concluded that OTC derivatives could represent a systemic threat to the U.S. financial system. In the GAO's view, "Although the federal government would not necessarily intervene just to keep a major OTC derivatives dealer from failing, the federal government would be likely to intervene to keep the financial system functioning in cases of severe financial stress." This moral hazard existed regardless of the federal government's lack of formal obligation to bail out financial intermediaries, other than banks, trading in derivatives. Again, according to the GAO, "While federal regulators have often been able to keep financial disruptions from

[649] U.S. General Accounting Office, "Financial Derivatives: Actions Needed to Protect the Financial System," Report to Congressional Requesters (May 1994): 3. Note the GAO was later renamed the Government Accountability Office.

becoming crises, in some cases intervention has and could result in industry loans or a financial bailout paid for by taxpayers."[650]

In addition, the GAO found that both industry and federal regulatory standards were insufficient to ensure that industry would, on its own, comprehensively follow good risk-management practices. The GAO noted:

> In such a rapidly growing and dynamic industry, new participants are likely to enter the market. Some of these new entrants may not be as knowledgeable as present dealers or may take on unwarranted risk in an attempt to gain market share or increase profits. In either case, systemic risk could increase.[651]

This concern played out in practice. As we have seen, while the Group of Thirty study provided benchmark corporate governance standards for use of OTC derivatives, those recommendations were not being consistently employed even by 1998.[652]

The issues and concerns about OTC derivative regulation broke down differently across the various financial services industries. Despite the fact that OTC derivatives were of growing importance to banks, broker-dealers, and insurance companies alike, there was little effort to bridge the significant gaps and differences across industry that existed in the regulation of the major OTC derivatives broker-dealers and end-users. For example, the GAO reported that, "Securities regulators have limited authority to oversee the financial activities of securities firm affiliates that conduct the OTC derivatives activities." On the other hand, the GAO discovered that, "Insurance companies' OTC derivatives affiliates are subject to limited state regulation and have no federal oversight."[653]

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[650] U.S. General Accounting Office, "Financial Derivatives," 6-7.
[651] U.S. General Accounting Office, "Financial Derivatives," 7-8.
[652] Lindsey, "OTC Derivatives in the U.S. Financial Markets," 1-2.
[653] U.S. General Accounting Office, "Financial Derivatives," 7-8.

At the other end of the regulatory spectrum, bank examiners had significant authority to regulate bank use of derivatives, but they did not employ them effectively because of a lack of expertise. As the GAO observed, "In contrast, bank regulators have authority to supervise all the financial activities of banks and their holding companies (but) their approach still has weaknesses, such as insufficient regulatory reporting requirements and inadequate documentation and testing of internal controls."[654]

The 1994 Proposed Regulation of Derivatives

In 1994, incoming House Banking, Finance, and Urban Affairs Committee Chairman Jim Leach recognized the value of requiring government oversight of the OTC derivatives market. As noted earlier, Leach was a self-made expert in financial matters much in the mold of Wilber D. Mills, who believed in the power of policy expertise.[655] At the time, Leach was particularly concerned with the nominal value of derivatives transactions. He observed that, "The multitrillion dollar derivatives activities of the ten largest American commercial banks alone amount to double the annual GNP of the United States." He further queried rhetorically, "If this doesn't define a pyramidal house of cards – particularly in the event of a market shock sparked abroad by warmongers or at home by private sector speculators or public pandering protectionists – what does?"[656]

Although his proposals ultimately were not voted into law, Leach used his remarks when introducing the legislation in 1994 to emphasize the potential risks inherent in allowing derivatives to remain in private markets as opposed to public exchanges. He recalled to the House a key finding from the 1993 minority staff analysis

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[654] U.S. General Accounting Office, "Financial Derivatives," 7-8.

[655] Julian E. Zelizer, *Taxing America: Wilbur D. Mills, Congress, and the State, 1945-1975* (Cambridge: Cambridge University Press, 2000) discusses the historical role played by strong Congressional committee chairs.

[656] James A. Leach, "Derivative Regulation,"1-12.

of derivatives regulation that he commissioned. Specifically, he called for "the international harmonization of standards, the standardization of documentation, and the development of protections against systemic risk" in the regulation of derivatives.[657] Leach noted that, "Unless derivatives are regulated by product type as well as institution kind, the market will simply be skewed to those market participants not subject, as commercial banks are, to safety and soundness scrutiny." This prescient observation would play out in the evolution of certain types of hedge funds as well as the actions of insurance companies and security broker-dealers.[658]

Leach also concurred with the GAO that the lack of regulation for OTC derivatives markets posed a threat to the entire financial system. He noted that this view was counter to the conventional wisdom that OTC derivative trading "is currently being conducted in a manner that does not adversely affect the safety and soundness of the financial system and does not represent significant systemic risk." He argued in reply that the magnitude of the OTC derivatives market as well as the growth rate in trading presented their own risks. Leach concluded, "Regulators have no choice except to establish as the highest possible priority the need to be vigilant in guarding against the potential risks to individual institutions and to the financial system as a whole posed by derivatives trading."[659]

Leach presupposed the need for federal oversight. Foreshadowing the failure of AIG in 2008, he observed that state-level regulators were unlikely to have adequate resources to oversee a large financial institution. However, Leach was unable to move his

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[657] James A. Leach, Working Papers (2009/2010): 6-7.
[658] Leach, "Derivative Regulation,"1-12.
[659] Leach, "Derivative Regulation,"1-12.

legislation out of committee despite independent assessments by the GAO as well as his own team of policy experts that increased government regulation of derivatives was necessary. In the end, he could not persuade his legislative colleagues to go against the conventional wisdom of the federal regulatory community and financial services industries, both of whom argued that self-regulation was better for the innovation and competitiveness of U.S financial markets. This leads to a consideration of the arguments by those opposed to increased regulation.[660]

Opposition to the Regulation of OTC Derivatives

Opposition to imposing government regulation on the OTC derivatives market as a whole was powerful. Market participants, including both broker-dealers and end users, were against additional market regulation because the flexibility of OTC trading allowed for more innovative and potentially more profitable contracts to be written. This effect can be seen in the preference for OTC derivatives over exchange traded futures and options contracts by a factor of six to one.[661] However, both the financial industries and policy community claimed their opposition was grounded in principle. This section discusses the major arguments that led to important safety and soundness provisions for the OTC derivatives market being delayed.

Key players offered several mutually reinforcing rationales against additional regulation. The financial industry trade association leaders argued that regulation was unnecessary because, in principle, derivatives reduced overall market risk. As Leach's

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[660] Marc Racicot, "AIG Crisis Restarts Debate Over State vs. Federal Insurance Regulation," Insurance Journal, September 17, 2008; Leach, "Derivative Regulation,"1-12. Although AIG's parent company was regulated by the Office of Thrift Supervision, at the time of the 2008 financial crisis it had 71 insurance subsidiaries regulated by different state and foreign jurisdictions.

[661] President's Working Group on Financial Markets, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," (November 9, 1999): 4.

minority report and the GAO's report highlighted, the financial service industry's basic premise was that derivatives could reduce risk in any given transaction. Unfortunately, the financial community extended this logic to conclude incorrectly that the OTC derivatives market, as a whole, reduced financial market risk rather than increasing it.[662]

As previously discussed, regulators such as Greenspan and Levitt were focused on the competitiveness of U.S. financial markets. It was unsurprising then that they also opposed increased regulation of the OTC derivatives market on the grounds that it would further reduce the competitiveness of U.S. markets. Both they and industry leaders concluded that increased regulation would have the effect of driving even more derivatives transactions to international exchanges. Finally, efforts to impose regulation were hampered by genuine disagreements on the best approach to regulation as well as infighting among the SEC and CFTC.[663]

As a result, both the financial industry and federal regulators joined together to stave off direct federal regulation of the OTC derivatives market. They jointly argued instead that the OTC derivatives market should be self-regulating. For example, in remarks consistent with those of his fellow commissioners, SEC Commissioner Carter Beese was dismissive of the urgency implied in the GAO report based on several recent failures among OTC derivative dealers. Beese appealed first to the power of market discipline. He observed that, "It is not a crisis when the market imposes discipline on those corporate treasurers who make mistakes when betting on the market." Beese then

[662] U.S. General Accounting Office, "Financial Derivatives," 3-8.

[663] President's Working Group on Financial Markets, "Letter to Senator Paul S. Sarbanes," December 15, 2000, entered into the Congressional Record by Senator Sarbanes (2 January 2001): S11946.

noted that it was in the best interests of the financial industry to provide effective self-regulation in order to "forestall sweeping regulatory oversight."[664]

Beese concluded his remarks with a familiar refrain among financial regulators of the 1990s, which was consistent with current secular trends of financialization and a desire by the U.S. government to foster a vibrant financial sector. He claimed, "In the U.S. we are walking a fine line between regulating prudently and regulating in such a heavy-handed manner that we drive business overseas." This point was at the crux of the matter. U.S. policymakers were vested in a view that self-regulation of the OTC derivatives markets was sufficient, but support for that approach was biased by the desire to enhance the competitiveness of U.S. markets by leveraging derivatives.[665]

Recognizing a potential threat to the evolving and free-wheeling derivatives market from governmental regulation, industry lost no time in engaging the SEC to propose a self-regulatory, or associational, solution to the problems identified by the GAO regarding the OTC derivatives market. Here is what the Securities Industry Association (SIA) had to say in a 1994 letter to the SEC about the formation of the Derivatives Policy Group (DPG):

> In view of our belief that the regulatory model embodied in the Securities Exchange Act of 1934 and the rules adopted pursuant to it do not provide a useful model for developing a supervisory mechanism for the dealers in this market, we propose a framework based on the voluntary participation of market participants in partnership with the SEC and other appropriate regulators. We believe that

[664] J. Carter Beese Jr., "OTC Derivatives: Key Regulatory Developments in the U.S." Remarks of SEC Commissioner J. Carter Beese, Jr. presented at the IBC Financial Focus OTC Derivatives Conference, London, UK (May 17, 1994): 3-5. For Beese, this was an exercise in managing public perceptions. His comment was that, "end users, senior management and regulators need to work together to alleviate public concerns regarding the regulation of this $12 trillion market."

[665] Beese, "OTC Derivatives: Key Regulatory Developments in the U.S."3-5

putting a voluntary structure into place would be more efficient and productive than developing other supervisory structures.[666]

The SEC commissioners accepted the logic of the SIA but also recognized that credible industry reporting standards would be necessary to defend market self-discipline as a reasonable alternative to market regulation. As a result, rather than issuing its own regulations the SEC requested that the Federal Accounting Standards Board (FASB), an independent self-regulating organization (SRO), develop accounting standards for both end-users and dealers in OTC derivatives. Gaining the support of the FASB was crucial because it served as the independent, not-for-profit private sector organization in the U.S. that establishes financial accounting and reporting standards for public and private companies as well as not-for-profit organizations that follow Generally Accepted Accounting Principles (GAAP). Ultimately, the FASB agreed with the SEC. FASB Chairman Dennis Beresford explained to Congress that it had established a project, "to develop improved accounting standards for derivative instruments, including derivatives used in hedging, that will result in credible information being provided to investors, creditors, regulators and all others who use financial statements in making economic decisions."[667]

Overall, the coordinated effort among the banking and securities industries and the SEC to stave off Congressional action mandating specific governmental regulation of the OTC derivatives market in the early 1990s was successful. No separate legislation

[666] Jeffrey L. Seltzer, "Supervisory Oversight of OTC Derivatives," Letter from Securities Industry Association to Brandon Becker, SEC Division of Market Regulation on (April 7, 1994): 1-5.

[667] Dennis R. Beresford, "FASB Proposed Statement of Accounting Principles Regarding Financial Derivatives," FASB Reply to Senator Gramm's Letter of 20 March, March 25, 1997. JT Ball Collection, University of Mississippi.

was passed to regulate OTC derivatives, with Congress opting instead to allow the market to evolve under the current regulatory structure in conjunction with industry self-regulation.[668]

The significance of the deliberate Congressional inaction in the early 1990s was that it retained a difficult and complex legislative environment to be overcome in any future effort to bring the derivatives markets under regulation. For example, any potential comprehensive financial services legislation would be subject to oversight by multiple Congressional committees, including the House and Senate Agriculture and Banking Committees, as well as the House Commerce Committee. At the same time, any Congressional efforts to deal with the issue of regulating OTC derivatives, whether in financial modernization or the periodic required review of the CFTC's authorizing statute (the CEA), faced scrutiny from banks, bond traders, derivatives traders, and the stock exchanges. Finally, congressional support for shifting the authority over derivatives to the CFTC faced significant opposition from government regulators such as the Federal Reserve, Treasury, and the Securities and Exchange Commission.

Risk Management Implications for Regulatory Policy

As new derivatives products were developed and the OTC market evolved throughout the 1990s, the financial policy community's perspective regarding regulation was shaped by two factors. One was a fundamental misunderstanding of the systemic risks that derivatives posed to the broader financial markets. The other was the free market bias that characterized the financial deregulatory environment in the late 1990s. From a public policy perspective, policymakers failed to recognize the externalities

[668] John Dingell and Edward Markey, "Letter to SEC Chairman Arthur Levitt on the Report from the Derivatives Policy Group," (March 13, 1995): 1-3.

imposed on the broader financial markets by OTC derivative trades. As a result, time and again federal regulators and Congress defaulted to market self-discipline and reliance on the institutional counterparties to correctly assess their own market risk rather than pursue market reforms. This persistent misunderstanding allowed significant systemic risks to develop all the while federal regulators and OTC market end-users and dealers believed that they were implementing mechanisms to reduce risk.

Risks to Bank Portfolios Were Known, Not Necessarily Understood

Although there were some policymakers concerned about regulating the expansion of derivatives, they misunderstood the nature of the problem. For example, federal banking regulators recognized the potential threat to the safety and soundness of individual banks that held and traded in OTC derivatives. However, the policy solutions that they posed relied on two flawed assumptions. One was that risk mitigation at the transactional level was sufficient to mitigate risks to the market as a whole. And the other assumption was that the individual banks correctly modeled their own transactional risks. In retrospect, these errors are explained by the technological complexity of the underlying securitized derivative products as well the sophistication of the models employed by the large financial institutions to manage them. However, federal regulators missed opportunity to correct the information asymmetry those models represented when they decided to rely on the financial institutions to model their own risk rather than developing government reference models for use in imposing regulatory controls over the market as a whole.

Let's first consider an example of how complex derivatives posed a market risk. Although derivative end-users and dealers, as well as federal banking and securities regulators, argued that institutional self-discipline was sufficient to mitigate systemic risks, they failed to account for the broader market risk created when all individual trades are based in the same underlying product. The general misunderstanding of the structural issues that were being created through the use of derivatives is illustrated by examining an overlooked flaw in the OTC derivatives market for mortgage backed securities (MBS) based on subprime mortgages. These particular MBS were built to reduce the risk of subprime mortgages through securitization, but the models used for securitizing those mortgages were inadequate. Specifically, the structure of the derivatives marketed based on those securities was vulnerable to falling housing prices.[669]

Although some regulators and policymakers grew uneasy about the growth of subprime mortgages throughout the 1990s, they viewed derivatives as a way to manage those risks. The issue was well documented by the bank examiners. According to FDIC Chair Donna Tanoue, "The consumer lending landscape has changed quite a bit over the last few years. One major change has been banks pursuing higher-rate loans to less creditworthy borrowers - a line of business known as "subprime" lending." She also pointed out that the risk was widespread, in that "we have identified 150 insured institutions engaged in some form of subprime lending as of June 1999."[670]

Later justifications aside, bankers and bank regulators knew by the late 1990s that an excess concentration in subprime mortgages was inadvisable. OCC data showed that

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[669] National Commission on the Causes of the Financial and Economic Crisis in the United States*, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, Authorized ed., 1st ed. (New York, NY: Public Affairs, 2011): 256-279.

[670] Donna Tanoue, "Remarks by Donna Tanoue Chairman Federal Deposit Insurance Corporation," presented at the Annual Convention American Bankers Association, Phoenix, Arizona (October 10, 1999): 1-3.

those institutions that focused on subprime mortgages faced double the risk of banks with more traditional lending portfolios as measured by net loan loss ratios. And that increased risk had clear consequences. As Comptroller of the Currency John Hawke testified, "Fraudulent activities, poor risk management practices for subprime and high-loan-to-value lending and asset securitization, and ineffective audits were important factors in the three national bank failures of 1999."[671] Similarly, the FDIC documented that five of nine bank failures in 1998-1999 were related to poor management practices associated with subprime mortgages.[672]

Yet from the perspective of the FDIC the problem was not the subprime mortgages per se. In Tanoue's view systemic risks only occurred through the failure to manage subprime instruments appropriately. She noted that traditional loan portfolio models had limited predictive power for subprime loans, especially since they had yet to be tested in poor economic conditions by the late 1990s. Hence the FDIC concluded that the risks to the federal deposit insurance funds should be mitigated either by minimizing the proportion of loans that were subprime or by hedging those subprime loans with derivatives.[673]

What bankers and bank regulators missed in this entire construct was that it was not the failure to correctly manage individual subprime mortgages and specific derivative contracts that led to systemic risk. The true danger to the whole financial market was that

[671] John D. Hawke Jr., "1999 Bank Failures and OCC Supervision," Testimony before the Committee on Banking and Financial Services of the U.S. House of Representatives, Washington, D.C. (February 8, 2000): 5.

[672] Donna Tanoue, "Remarks by Donna Tanoue Chairman Federal Deposit Insurance Corporation," presented at the America's Community Bankers, Orlando, FL (November 2, 1999): 1-2.

[673] Tanoue, "Remarks by Donna Tanoue Chairman Federal Deposit Insurance Corporation," 1-3.

the entire edifice was built on the presumption of rising housing prices. While bankers and other titans of Wall Street apparently believed they were reducing transactional risk by devising ever cleverer and remunerative ways to divide the tranches from securitized mortgages based in subprime mortgages, the fact remained that all of the tranches were grounded in the value of the underlying mortgage. If housing prices fell many mortgages could not be repaid, which led to a systemic crisis in the derivatives market when swaps based on the mortgage-backed securities could not clear, thus freezing the market. This sequence of events is essentially what happened to U.S. financial markets in 2008, when commercial banks, investment banks, and insurance companies were all counterparties to a concentrated risk in MBS swaps.[674]

Now, let's further consider the flawed assumption that regulators could rely on large financial institutions to model their own risks. Bank examiners understood quite well that derivatives posed a risk, but they considered the hazard to be related to individual banking institutions rather than to the entire market. Consider the views of William McDonough, who was President of the Federal Reserve Bank of New York and Chair of the Bank for International Settlements (BIS) Basel Committee on Bank Supervision. McDonough asked rhetorically in the Federal Reserve Bank of New York 1997 Annual Report, "How do we ensure that the capital framework is sufficiently broad to reflect the growing tendency of financial institutions to take on and manage banking, insurance, and securities risks by using derivatives and insurance products?"[675]

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[674] National Commission, "*The Financial Crisis Inquiry Report,*" xv-xxv.

[675] Rich Whiting and Ed Hill, "Report on Guiding Principles of Risk Management," The Bankers Roundtable, March 22, 1999, Citi Heritage Collection, RG5, Box 18, Accession 2012-54, p. 10-11.

The Federal Financial Institutions Examination Council (FFIEC), which was chartered to ensure consistent regulatory standards among the federal banking examiners, tried to address McDonough's question with new guidelines in May 1998.[676] The FFIEC specifically issued a new and revised *Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities* to define safe and sound practices for managing the risk of derivatives. The most notable change in this so-called "1998 Statement" was elimination of rules focused exclusively on mortgage backed derivative securities (MBS) in favor of rules that required an assessment of all investments relative to the balance sheet.[677]

Superficially, this move represented an improved approach to managing risk, but it masked a crucial flaw that was inherent in the thinking of bankers and bank regulators alike. To wit, it made the fatal assumption that the bankers would correctly evaluate the risk to their portfolios.[678] The ABA reported that, "The 1998 Statement requires the bank's board to establish specific 'market risk' limits for the balance sheet that management must operate within." Or, more simply, the bank investment officer must

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[676] "About the FFIEC." Accessed November 28, 2017. https://www.ffiec.gov/about.htm; The FFIEC is an interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve, FDIC, OCC, and the National Credit Union Administration (NCUA). It later added the Consumer Financial Protection Bureau (CFPB). It included a State Liaison Committee composed of five representatives of state supervisory agencies.

[677] Robert Colvin, "New rule marks major shift in investment policy," *ABA Banking Journal* 90, No. 7 (July 1998):48-50.

[678] Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation* (Washington, D.C.: Peterson Institute for International Economics, 2008), 87-135. The Basel Committee took the same approach to developing capital reserve margin requirements through internal ratings based risk models as it developed the 2004 Basel II accord.

justify to the regulatory auditor the impact of each security on the interest rate risk faced by the bank, leveraging the banks' own risk assessment to do so. In other words, the auditors provided no independent assessment of the banks' risk models.[679]

Reliance on the banks' own risk management models was partly driven by the growing complexity of the financial markets. Alan Greenspan noted that large banks had a "vast array of complex hybrid financial products... (that) seemingly challenges human understanding." The irony that this might apply to bank executives as well appears to have been lost on the Maestro.[680] According to *ABA Banking Journal* contributing editor Ed Blount, "The regulators have concluded that it would be impossible for them to continue to apply traditional supervisory techniques to global banks that are engaged in such complex activities as derivatives trading." Instead, bank supervisors changed their approach to "examine for the adequacy of banks' risk management systems compared to the banks' business strategy."[681]

The flaw here has become obvious in retrospect. If the market participants and regulators fail to understand the underlying risk of the security, as happened with credit default swaps and collateral debt obligations in 2008, then the models run by each bank would effectively be meaningless in assessing the interest rate risk. That is, the models would merely predict the effect the derivative was intended to achieve. This flaw was to have grave consequences, because it led to a bank regulatory philosophy that relied on

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[679] Colvin, "New rule marks major shift in investment policy,"48-50.

[680] Bob Woodward, *Maestro: Greenspan's Fed and the American Boom* (New York: Simon & Schuster, 2000).

[681] William W. Streeter, "Risk Rethinking and Web Adjustments," *ABA Banking Journal* 91, No.1 (January 1999):15.

the marketplace to constrain banks in preference to establishing regulatory oversight of the OTC derivatives market itself!

Free-market Bias and Policy Failures

The federal regulators knew full well that reliance on market self-discipline would result in significant losses to individual institutions on the wrong end of trades. As Greenspan put it, "New instruments, like derivatives, afford the opportunity to reduce risk, but they also afford opportunities to become more vulnerable."[682] Here Greenspan reiterates his free market bias, arguing that private financial intermediaries have the most incentive and best chance, through self-regulation, to impose market discipline:

> It is, thus, all the more important to recognize that twenty-first century financial regulation is going to increasingly have to rely on private counterparty surveillance to achieve safety and soundness. There is no credible way to envision most government financial regulation being other than oversight of process…As the complexity of financial intermediation on a worldwide scale continues to increase, the conventional regulatory examination process will become progressively obsolescent—at least for the more complex banking systems."[683]

What is interesting is that Greenspan, as well as the majority of the policy community, maintained this faith in market self-discipline despite convincing evidence that the sophisticated counterparties were failing to anticipate and mitigate risks. For example, it was not surprising that Russia's technical default on 17 August 1998—just months before Greenspan's comment-- led to a collapse in the Russian credit market. But in what should have been a clear warning, U.S. financial counterparties that owned default options were unable to collect on Russian credits when some foreign exchange

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[682] Alan Greenspan, "Structure of the U.S. Financial System," Remarks presented at the Annual Meeting of the Securities Industry Association, Boca Raton, Florida (November 5, 1998): 10.

[683] Greenspan, "Structure of the U.S. Financial System," 13.

contracts were not honored by Russian debt counterparties, leading to a cascade of defaults among western financial institutions.[684]

Most importantly, the much-praised, model-based risk management systems of Wall Street's investment and commercial banks were known to fail to accommodate unexpectedly volatile markets. Bankers Trust Corp., J.P. Morgan, and Merrill Lynch & Co. all had trading losses that exceeded their value-at-risk (VAR) estimates. As *Institutional Investor* reported, "Every expert knew that VAR becomes unreliable in very volatile markets, but few were prepared for the crashing credit markets."[685]

The policy implications were clear. Faced with known risks in financial markets driven by increasing complex securitization products, from international exchange rates to subprime mortgages, federal regulators put their faith in the large institutional investors' ability to manage their own exposure to derivatives. This reflected a free-market bias towards market self-discipline and an expectation that only the counterparties to a given trade would suffer if the trade went bad. Ironically, the risk mitigation mechanisms that the financial institutions increasingly relied on were derivative products designed to meet the specifications of their sophisticated risk models. Unfortunately, these models shared a common flaw. They did not consider the possibility that the market for the commodity or products that underpinned the derivatives itself could fail.

The fact that Greenspan as well as most other leading policy makers in the financial community were persuaded by their free-market bias to prefer self-regulation to market regulation had significant ramifications. In particular, it led them into a public policy error regarding the ability of OTC markets to clear when their pricing mechanism

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[684] "Blackened Scholes," *Institutional Investor* 33, no. 1 (January 1999): 83.
[685] "Blackened Scholes," *Institutional Investor* 33, no. 1 (January 1999): 83.

failed. Their misunderstanding was to assume only the counterparties to a trade were at risk, when in reality both the size of the nominal derivatives market and growing complexity of interlocking trades put the entire financial system at risk. This externality justified public policy intervention to mitigate systemic risks created by new financial products, institutions, and markets. Yet even though this was recognized by some contemporary observers, regulatory disputes led to the omission of constructive safety and soundness measures from the regulatory structure put in place to provide oversight of hedge funds and OTC derivatives markets.

Regulatory Disputes Regarding OTC Derivatives in the Late 1990s

A struggle for regulatory oversight over OTC derivatives emerged in the late 1990s as the market for derivatives grew in value, volume, and complexity of products. Unlike the disputes regarding the repeal of Glass-Steagall, which generally were among the federal banking examiners, SEC, and state insurance commissioners, in the case of OTC derivatives the policy dispute was largely between the CFTC Chair and the other members of the President's Working Group on Financial Markets (Working Group).

Brooksley Born was appointed to head the CFTC in 1996 by President Clinton. An experienced regulatory attorney with the Washington power firm Arnold and Porter, Born came to the job with a personal insight into how the financial system could be manipulated. For example, she had represented the London Futures Exchange before the CFTC, as well as a major Swiss bank in litigation against the Hunt brothers when they famously tried to corner the silver market. Born herself argued that her call for governmental regulation of the OTC derivatives market simply reflected an empirical observation about growing risks. She later attributed the resistance she encountered from Alan Greenspan and Robert Rubin, who both argued that derivatives were not within the

CFTC's regulatory purview, to a combination of differences in regulatory philosophy and bureaucratic turf battles.[686]

In many ways, the differences between Born on the one hand and Greenspan, Rubin, and Levitt on the other shows how previous institutional developments hindered efforts to reform the financial system. In particular, this divergence of regulatory views contributed to a decision by Congressional leaders to separate the legislative issues of Glass-Steagall repeal and OTC derivative regulation, which as a practical matter prevented a comprehensive approach to financial services modernization.

The resolution of the dispute among the leading regulators had important long-term implications for U.S. financial markets. The issue nominally revolved around the question of whether the systemic risk from OTC derivatives would be better mitigated by regulating the derivatives market itself or by perpetuating the evolving system of market self-regulation. Born in particular advocated increased governmental regulation focused on safety and soundness of U.S. markets and institutions, whereas her colleagues on the Working Group advocated market self-regulation with an eye towards the global competitiveness of U.S. financial markets. The victory of the latter view contributed to the omission of required safety and soundness features from financial modernization legislation.

SEC and CFTC Battle for Control

The regulatory debate over derivatives in the late 1990s was largely played out as a struggle between the SEC and CFTC for oversight of the OTC markets, with the

[686] Richard B. Schmitt, "The Born Prophecy," *ABA Journal*. Accessed January 13, 2019. http://www.abajournal.com/magazine/article/the_born_prophecy/.

Federal Reserve and Treasury siding with the SEC. Both sides of the debate were driven by the emerging importance of the OTC derivatives market, concerns over recent failures in the broader financial markets instigated by transactions in derivatives, such as the $7.6 billion Orange County bankruptcy, as well as the flight of the derivatives trades to overseas markets. Regardless, the competing regulatory interpretations of the law left the respective agencies in a seemingly intractable position.[687]

One the one hand, SEC Chairman Levitt offered SEC oversight of the derivatives market with a commitment to retain self-regulation by broker-dealers and end users. On the other hand, CFTC Chairwoman Born proposed a significant change to the status quo by implementing strict CFTC authority over the OTC derivatives market similar to her authority over the Chicago commodities and futures exchanges. Of course, this issue was not as simple as trading a policy favoring U.S. competitiveness over one favoring government regulation of markets. Levitt surely believed that market self-regulation was sufficient for safety and soundness, and Born similarly pointed to the value of U.S. futures markets as globally leaders. However, the practical result of this power struggle was ultimately a policy that favored retaining self-regulation in order to ensure competitive U.S. financial markets.

Beginning with her appointment as CFTC Chairwoman in 1996, Born began to argue that all derivatives should be made to conform to common standards and trade on futures exchanges under CFTC oversight because, as a practical matter, derivatives acted like futures contracts. She also claimed that the Commodity Exchange Act as amended in 1974 provided authorization for the CFTC to regulate derivatives. This interpretation was

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[687] Lindsey, "OTC Derivatives in the U.S. Financial Markets,"1-2.

not unreasonable, given the modification of the Commodity Exchange Act in 1974 to include under the authority of the CFTC not only physical commodities but also "services, rights, and interests, in which contracts for future delivery are presently or in the future dealt in."[688]

However well intended in terms of establishing regulatory structure, Born's assertion was not widely accepted either among industry or the financial policy community. To complicate matters, SEC officials contended that legal and regulatory precedent implicitly authorized the SEC oversight of OTC derivatives, not the CFTC. The SEC staffers pointed to a 1992 Commodity Exchange Act amendment that restricted the CFTC from regulating derivatives between private counterparties, whether or not they were executed on an exchange or over the counter.[689]

In point of fact, neither the regulation of derivative transactions nor the OTC markets as a whole were clearly addressed in the Commodity Exchange Act. To the extent that any such authority over derivatives could be inferred from language concerning futures exchanges, the simple fact was that the CFTC had not previously exercised it. Instead, both the SEC and federal banking supervisors had undertaken to regulate the evolving derivatives market by imposing requirements on the securities brokers or banks that created and traded derivatives over the counter.[690]

In December 1997, three years after the GAO Report and Leach's unsuccessful attempt to introduce legislation to regulate derivatives, Levitt and the SEC made a

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[688] Greenblatt, "Finance: Open Outcry,"1131–33.

[689] Greenblatt, "Finance: Open Outcry,"1131–33.

[690] Jickling, "CRS Report: RS20560," 1-2; Group of Thirty Global Derivatives Study (July 1993)," in Lissa L. Broome and Jerry W. Markham, *Regulation of Bank Financial Service Activities: Cases and Materials*. 3rd ed. American Casebook Series (St. Paul, MN: Thomson/West, 2008): 811.

preemptive move that overtly claimed the lead in regulating the OTC security derivatives market. Specifically, he introduced for comment an OTC derivatives dealer proposal, sometimes known as "Broker-Dealer Lite." The proposal was intended to reduce regulatory burden on derivative dealers with the intent of keeping U.S. financial markets competitive globally. That is, the explicit intent was to retain and grow the OTC derivatives trading market in the U.S.[691]

By way of background, under contemporary rules dealers in OTC securities derivatives were required to register as broker dealers and meet SEC capital and margin requirements. Many chose instead to move their securities derivative trades abroad through foreign affiliates, particularly on the London Futures Exchange where no capital restrictions were imposed on derivatives traders. Although higher risk, this strategy allowed both dealers and end users to trade with much higher levels of leverage, which magnified potential profits. "Broker lite" was intended to allow U.S. securities firms to conduct all derivatives transactions through one U.S. based agent with reduced regulatory burden and increased flexibility for the securities dealers. Levitt claimed that "Broker Lite" would not expand SEC authority, and was merely intended to improve efficiency of U.S. derivatives market with an explicit goal of ensuring the domestic derivatives markets become preferred to overseas markets.[692]

In response, Born undertook a public campaign to undermine the SEC's position and establish the CFTC's authority over the derivatives market. Unfortunately, her

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[691] Exchange Act Release No. 39454 (Dec. 7, 1997), 62 FR 67940 (Dec. 30, 1997)

[692] Arthur Levitt, "Testimony of Arthur Levitt, Chairman U.S. Securities and Exchange Commission Regarding the Regulation of the OTC Derivatives Market and Hybrid Instruments," Presented to the Committee on Banking and Financial Services, U.S. House of Representatives, Washington, DC (July 30, 1998): 8-9.

approach introduced concern among derivatives end-users and broker-dealers that the CFTC would invalidate the legality of prior OTC derivatives contracts and also raise trading costs on future transactions. Born's first step was to take public issue with the SEC Broker-Lite proposal in letter to the SEC, noting the proposal inappropriately appeared to cover certain derivatives under CFTC jurisdiction.[693]

Born's criticism of Broker-Lite caused the derivatives market participants to be concerned that the CFTC was denying the applicability of a 1983 agreement called the Shad-Johnson Accord between the SEC and CFTC, which primarily prevented futures trading on single stocks. Her claim that the CFTC had authority over certain categories of exempt swaps created legal uncertainty among market participants. That is, treating the swaps as futures contracts might render the transactions invalid since they had been created as derivatives and not as futures contracts. Not surprisingly, the financial services trade association leadership completely opposed this interpretation.[694]

In May1998, Born escalated the jurisdictional dispute by publishing a concept paper that criticized the ways in which OTC derivatives were regulated under the self-regulatory system. The paper was included in a request for comments on proposed regulatory rules as to whether or not OTC derivatives transactions were being effectively regulated, especially as regards exemptions from CFTC oversight under the Commodity Exchange Act. The concept release was especially controversial because it requested comments on establishing a clearing market under the strict supervision of the CFTC. Industry and other federal regulators interpreted the CFTC proposal as an attempt to

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[693] Letter from Jean A. Webb, Secretary, CFTC, to Jonathan G. Katz, Secretary, SEC (Feb. 26, 1998).

[694] The Shad-Johnson Accord was a 1982 agreement between SEC Chair John Shad and CFTC Chair Phil Johnson that prohibited the creation of single stock futures.

overturn the current regulatory structure, with the CFTC taking governmental oversight of OTC derivative transactions. [695]

Born's rationale for the concept paper, much as Leach had outlined in 1993, was to ensure that a regulated market was established for clearing OTC derivatives. Her approach was to have the CFTC provide strict oversight of the derivatives market to ensure that the same derivative products would be regulated effectively regardless of institution selling or leveraging the derivative. This of course was a direct challenge to the SEC's Broker-Lite proposals.[696]

The battle between the SEC and CFTC unsettled the financial markets. It quickly made its way to Congress because, lacking clear jurisdiction, there was no mechanism for the regulators to settle the dispute other than going to court, which would have taken years to resolve. In testimony before the House Banking Committee, Levitt credited Congressional forbearance in not undertaking legislative steps that would inhibit market innovation. Levitt maintained that OTC derivatives were growing in importance because they helped governments lower costs, as with mortgage backed securities, enabled corporations manage exchange rate risk, and banks manage interest rate risk. He also argued that the growth in the derivatives market was enabled by an effective approach to developing legal certainty and sound financial industry practices, including SROs such as the Derivatives Policy Group (DPG). [697]

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[695] Commodity Futures Trading Commission, "Over the Counter Derivatives," Concept Release, Proposed Rules to 17 CFR Parts 34 and 35, Federal Register Vol 63, No. 91, 12 May, 1998, http://www.cftc.gov/files/foia/fedreg98/foi980512a.pdf.

[696] "Born Free," *Institutional Investor* 33, no. 2 (February 1999): 16.

[697] President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," (April 28, 1999): F-1 explains that, "The Derivatives Policy Group ("DPG") was formed by six major Wall Street firms in

Levitt then raised two specific concerns about Born's CFTC concept paper. First, regarding competitiveness, he observed Born's approach would stoke industry fears about imposed regulatory costs, which might exacerbate the movement of the market for derivatives overseas. Second, Levitt noted that her approach would create legal uncertainty, destabilizing the market for derivatives, hybrid and other swaps. In particular, the Levitt noted that the CFTC concept paper raised the possibility of applying a comprehensive regulatory scheme to swaps and hybrids, which presumed arbitrarily that derivative products should be classified as futures and subject to CFTC oversight under the Commodity Exchange Act. This would have brought into question the legality of a decade worth of OTC derivative contracts enacted among private counterparties that had not been conducted on exchanges under the supervision of the CFTC.[698]

The SEC Chairman argued further that there had been no clear need demonstrated for new statutory regulation of OTC derivatives since the Working Group last testified to

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August 1994, to respond to the public policy issues raised by the OTC derivatives activities of unregulated affiliates of SEC-registered broker-dealers and CFTC-registered futures commission merchants ("FCM"). The DPG is a voluntary framework designed to provide the SEC and the CFTC with information and analyses that would permit them to more systematically and rigorously evaluate the risks associated with OTC derivative products. The voluntary framework applies to affiliates of registered broker-dealers and FCMs that: (1) are not subject to supervisory oversight with regard to capital; (2) primarily serve as OTC derivatives dealers; and (3) conduct OTC derivatives activities that are likely to have a material impact on their registered broker-dealer affiliates or FCMs. The voluntary oversight framework for members consists of four interrelated components: management controls, enhanced reporting, evaluation of risk in relation to capital, and counterparty relationships."

[698] Arthur Levitt, "Testimony of Arthur Levitt, Chairman U.S. Securities and Exchange Commission Regarding the Regulation of the OTC Derivatives Market and Hybrid Instruments," Presented to the Committee on Banking and Financial Services, U.S. House of Representatives, Washington, DC (July 30, 1998): 4-6. Levitt defines hybrid instruments as "depository instruments or securities products, such as debt or equity securities, that have one or more commodity-dependent components with payment features similar to commodity futures or commodity option contracts."

Congress on OTC derivatives in 1994, or since the CFTC, SEC, industry, and the DPG, an industry SRO, had established a framework for voluntary oversight. Levitt stated firmly, "Indeed, questions relating to what kind of regulation, if any, is appropriate for this market are ones that should not be addressed by an agency acting under a statute intended to govern only exchange trading in futures and commodity options." He was adamant that while the Commodity Exchange Act granted the CFTC authority to regulate exchange traded futures, nowhere in Act was the CFTC given authority to regulate off-exchange or OTC transactions.[699]

Jeff Seltzer of the SIA, speaking for the securities industry, concurred with the SEC position that, "Traditional swaps that are not traded through a multilateral transaction execution facility are not futures and are not subject to regulation under the CEA." Overall, the SEC and the securities industry were aligned: U.S. financial markets would be best served by light government oversight of the OTC derivatives market, with self-regulation to set standards in order to foster innovation, enhance the competitiveness of U.S. markets, and prevent migration of activity overseas.[700]

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[699] Arthur Levitt, "Testimony of Arthur Levitt, Chairman U.S. Securities and Exchange Commission Regarding the Regulation of the OTC Derivatives Market and Hybrid Instruments," Presented to the Committee on Banking and Financial Services, U.S. House of Representatives, Washington, DC (July 30, 1998): 4-8. Levitt argued that OTC derivative transactions should not be regulated as an exchange because the purpose of an exchange was to set prices. However, a derivatives trade set the price of the derivative security itself, but not the underlying product (e.g., the mortgages that underpinned mortgaged backed securities).

[700] Jeffrey L. Seltzer, "Letter from Securities Industry Association to Brandon Becker, SEC Division of Market Regulation on Supervisory Oversight of OTC Derivatives," (April 7, 1994: 1-5.

Federal Reserve Emphasizes Market Self-Discipline in OTC Regulation

The Board of Governors of the Federal Reserve supported Levitt's position in written testimony that offered an impassioned defense of the free market and market discipline to self-regulate OTC derivatives. The Board put this matter plainly to Congress, saying, "The issues under consideration really are not so much issues of which government agency should regulate these transactions as they are issues of whether government regulation is necessary and, if so, what types of regulations are appropriate." Of course, the Board did not believe it was abrogating its responsibility for safety and soundness. Rather, they argued market self-regulation was sufficient for this purpose, and was preferred in order to ensure U.S. competitiveness.[701]

Indeed, the Board made a public policy case against CFTC regulation of the OTC derivatives market. They pointed out that the purpose of the CFTC under the Commodity Exchange Act was to ensure the integrity of commodity markets, prevent commodity market manipulation, and to protect market participants from fraud or the insolvency of their counterparties. However, in the case of OTC derivative transactions, the Board was of the view that private market discipline served those public policy functions. They claimed the difference between the OTC derivatives market and futures exchanges was that the private contracts were settled in cash rather than in delivered products, and the cash delivery was based on a rate or price from a large market not subject to manipulation. That is, the settlement prices could not affect the price of the underlying

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[701] Board of Governors of the Federal Reserve System, "Statement Submitted by the Board of Governors of the Federal Reserve System to the Subcommittee on Risk Management and Specialty Crops of the Committee on Agriculture, U.S. House of Representatives, June 10, 1998," *Federal Reserve Bulletin* 84, no. 8 (August 1998): 636-639.

transactions (e.g., a credit default swap does not affect the underlying mortgage terms). In separate testimony, Alan Greenspan added that it was not possible to corner a market when the underlying asset is essentially an unlimited supply (e.g., foreign exchange, government securities, or pegged interest rates).[702]

In further support of Levitt, the Board argued that the CFTC Concept Paper "marks an important departure from precedent." It claimed that, "Neither the Congress nor the CFTC has to date made a determination that OTC derivatives are subject to the CEA." Noting that they had followed the issue of regulating OTC derivatives closely for ten years, the Board wrote that it was, "Deeply concerned about any legal or regulatory development that calls into question the enforceability of a significant volume of such transactions." Yet from their perspective that was exactly what Born had done. In other words, "Because the CEA generally requires instruments covered by the act to be traded on an exchange, if OTC derivatives were covered, they might be illegal and unenforceable."[703]

Finally, the Board suggested that large, sophisticated counterparties were able to protect themselves and did not need government oversight of their private transactions. This is an important aspect of the free-marketers' concept of market self-discipline,

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[702] Alan Greenspan, "Regulation of Over the Counter Derivatives,"1-9. Chairman Greenspan presented similar testimony before the Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, July 30, 1998; Board of Governors, "Statement Submitted June 1998," 636-639; Board of Governors, "Statement Submitted June 1998," 636-639. Ironically, Greenspan used the London Interbank Offered Rate (LIBOR) as an example here, which of course was famously manipulated by a bevy of international banks from 2005-2008. This issue has been the subject of several recent books. See for example, Liam Vaughan and Gavin Finch, *The Fix: How Bankers Lied, Cheated and Colluded to Rig the World's Most Important Number* (Chichester, West Sussex, United Kingdom: Wiley, Bloomberg, 2017).

[703] Board of Governors, "Statement Submitted June 1998," 636-639.

which drew a distinction between trades on exchanges available to the public and private transactions. The Federal Reserve acknowledged that regulation is required to prevent the average customer from fraud on securities exchanges open to the public. But that was not the case for OTC derivatives, which were not available to the public. Hence, the Board argued that the large sophisticated counterparties to OTC trades should be allowed to go at risk because they were able to make informed judgements and bear the market losses if incorrect.[704]

Note here that the point made earlier by Leach, that the size of the OTC market presents its own systemic risk, has been lost to the argument. As we will see, the size issue was nominal rather than real. If regulated markets existed to ensure that the derivatives transactions cleared, then the actual exposure both at the institutional and market levels would have represented a transactional risk rather than a systemic risk.

Chairman Greenspan acknowledged that reliance on market discipline inherently meant that there would be market losses. As he remarked in testimony to the House:

> I do not mean to suggest that counterparties will not in the future suffer significant losses on their OTC derivatives transactions. Since 1994 the effectiveness of their risk management skills has not been tested by widespread major declines in underlying asset prices. I have no doubt derivatives losses will mushroom at the next significant downturn as will losses on holdings of other risk assets, both on and off exchange.[705]

Rather than leading to market instability, he believed market discipline was what allowed markets to function. The principle at issue here is that market discipline is enforced by private gain and loss. Greenspan added, “I see no reason to question the underlying

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[704] Board of Governors, “Statement Submitted June 1998,” 636-639. The GAO did an October 1997 study documenting large losses in OTC derivatives, which appeared to contradict this position. The Board did a closer look, and the vast majority of cases examined (~80%) were mortgage backed securities, for which federal guidelines exist.

[705] Greenspan, “Regulation of Over the Counter Derivatives,”5-8

stability of the OTC markets, or the overall effectiveness of private market discipline, or the prudential supervision of the derivatives activities of banks and other regulated participants." In other words, in his view the markets would function even if particular counterparties suffer losses.[706]

Despite its free-market bias, the Board suggested that, if in the future counterparties to OTC derivative transactions sought to establish centralized clearing facilities in order to improve transparency and liquidity as well as make the transactions more efficient, then market regulation might be appropriate. It noted that, "If counterparties were to choose to develop such facilities, some type of government oversight generally may be appropriate to supplement the private self-regulation that the counterparties would provide." Further, if that were the case, the Board stated it would recommend the SEC or one of the bank regulators for federal oversight in preference to the CFTC, which was chartered for a different mission.[707]

President's Working Group Actions Separate the Derivatives Question From GLBA

In addition to their separate testimony, Chairwoman Born's colleagues on the President's Working Group on Financial Matters (Working Group) jointly opposed her concept paper to Congress. As will become clear, the resulting Congressional actions ensured that financial services modernization could not be comprehensive reform.

In May 1998, Greenspan, Levitt, and Rubin first took the extraordinary step of issuing a joint public statement of solidarity against one of their own Working Group members. This unprecedented rebuke opposed Born's concept release immediately and unequivocally, clearly separating the agencies with traditional responsibilities for

[706] Greenspan, "Regulation of Over the Counter Derivatives,"5-8
[707] Board of Governors, "Statement Submitted June 1998," 638-639

financial markets from the CFTC, which heretofore had exercised no such authority.[708]

They declared in part:.

> On May 7 (1998), the Commodity Futures Trading Commission ("CFTC") issued a concept release on over-the-counter derivatives. We have grave concerns about this action and its possible consequences. The OTC derivatives market is a large and important global market. We seriously question the scope of the CFTC's jurisdiction in this and we are very concerned about reports that the CFTC's action may increase the legal uncertainty concerning certain types of OTC derivatives.[709]

They went on to say that, "The concept release raises important public policy issues that should be dealt with by the entire regulatory community working with Congress and we are prepared to pursue, as appropriate, legislation that would provide greater certainty concerning the legal status of OTC derivatives."[710]

In June 1998, Levitt, Greenspan, and Rubin made an even more pointed joint request to Congress. This time they asked for legislation to temporarily prevent the CFTC from taking unilateral action on regulating the OTC derivatives market. Their goal was to allow time for the Working Group to make recommendations to Congress, and for Congress to consider appropriate policy choices for legislation.[711]

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[708] Gramm, Interview, January 16, 2018. It was notable to Gramm that not one of Born's peers agreed with Born. He observed that Congress took the extraordinary step of prohibiting the implementation of her regulatory concept based on the concerns about legal uncertainty raised by Rubin, Greenspan, and Levitt all with one voice.

[709] "Joint Statement by Treasury Secretary Robert E. Rubin, Federal Reserve Board Chairman Alan Greenspan, and Securities and Exchange Commission Chairman Arthur Levitt," SEC Historical Society (May 7, 1998): 2.

[710] Rubin, Greenspan, and Levitt, "Joint Statement," 2.

[711] Robert E. Rubin, Alan Greenspan, and Arthur Levitt, "Letter to The Honorable Newt Gingrich, Speaker, U.S. House of Representatives, from the Secretary, Department of the Treasury, Chairman, Board of Governors of the Federal Reserve System, and Chairman, Securities and Exchange Commission," 5 June 1998.

In response to this joint appeal, Congress instituted a moratorium to prevent the CFTC from implementing regulation of OTC derivatives until March 1999.[712] Further, the respective chairmen of the Senate and House Agriculture Committees, Senator Richard Lugar, R-IN, and Representative Robert Smith, R-OR, wrote a joint letter to Secretary Rubin in September 1998 requesting that the Working Group conduct a study of OTC derivatives markets and provide legislative recommendations to Congress within one year, or September 1999.[713]

In a related matter, the other CFTC commissioners, including David D. Spear, James E. Newsome, and Barbara A. Holum abandoned the CFTC "concept paper" and confirmed their continued commitment to withhold action on OTC derivatives prior to September 30, 1999 or "prior to Congress having the opportunity to review and analyze issues relating to OTC derivatives." Chairman Born, at this point effectively isolated and out of step with her colleagues, elected not to pursue re-nomination as Chair of the CFTC when her term expired in June 1999.[714]

The controversy among the CFTC and other federal advisory bodies was set aside by deferring the resolution of this controversy until a report out of the Working Group. One important result of deferring the OTC derivatives policy question was that as a practical matter the parallel financial modernization legislation focused on repeal of

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[712] Agriculture, Rural Development, Food and Drug Administration, and Related Agencies Appropriations Act, 1999, § 760, as enacted in Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999, Pub. L. No. 105-277, 112 Stat. 2681, 2681-35 (1998)

[713] H.R. Rep. No. 825, 105th Cong., 2d Sess. 991-92 (1998); Letter from the Honorable Richard G. Lugar, Chairman, Senate Committee on Agriculture, Nutrition, and Forestry, and the Honorable Robert Smith, Chairman, House Committee on Agriculture, to the Honorable Robert Rubin, Secretary of the Treasury (Sept. 30, 1998).

[714] "The Collapse of Long-Term Capital Management," Hearings before the Senate Agriculture Committee, Washington, D.C. (December 16, 1998).

Glass-Steagall, eventually to become GLBA, could not include reform of the OTC derivatives market. Given that the Working Group would not report out before September 1999, and the stated intent of congressional leaders to complete financial services modernization legislation by the end of the first session of the 106th Congress (1999), the timing no longer worked.

Instead, as Undersecretary of the Treasury Gensler pointed out, the deferral of the derivatives issue until after September 1999 aligned the question of regulating the OTC derivatives market with the upcoming review and renewal of the CFTC, as required by the Commodity Exchange Act, which was due in 2000. This was generally thought to be appropriate by the policy community because the regulation controversy revolved around the meaning of "futures" and "exchanges" in the Commodity Exchange Act, and consequently directly called into question the role of the CFTC versus the other federal financial regulatory bodies.[715]

Unfortunately, the separation of the two issues in the minds of industry leaders, regulatory officials, and Congressional members created the circumstances for a historic omission. Specifically, the decision by Congressional leaders to grant the joint request by the Working Group to defer action on the regulation of OTC derivatives meant that financial services modernization legislation would proceed focused solely on the deregulation of Glass-Steagall. As a result, the legislation that eventually became GLBA did not incorporate regulatory structures to ensure the safety and soundness of new products, institutions, or markets that potentially created new systemic risks.

[715] Gary Gensler, "Remarks by Under Secretary of the Treasury," Presented at the Bond Market Association Annual Legal and Compliance Conference, Washington, D.C. (November 1, 1999): 1-4.

The Bailout of Long-Term Capital Management: Canary in a Coal Mine?

The near failure and bailout of the hedge fund Long-Term Capital Management (LTCM) in 1998 is a case study in how policymakers were influenced by their desire to enhance and protect the competitiveness of U.S. financial markets by supporting self-regulation over governmental regulation of the OTC derivative markets. The failure of LCTM provided ample warning that relying on complex models was insufficient to mitigate risks to individual financial institutions. Models could be wrong. More tellingly, the LCTM case clearly showed for the first time that the failure of a large hedge fund making use of OTC derivatives could put the entire financial system at risk via the counterparties' exposure. Indeed, the lessons of LTCM were clear enough that the Working Group actually identified and published appropriate safety and soundness measures in response. As we will see, these mechanisms included transaction close-out and netting rules designed to help clear the derivatives markets. However, a misunderstanding of the how the crisis was resolved led the policymakers to conclude incorrectly that market self-discipline rather than market regulation was sufficient to apply those measures. This error was perpetuated when Congress later deliberately omitted a requirement to implement known safety and soundness measures from legislation intended to address regulation of the OTC markets.[716]

The LCTM Bailout: Market Self-Discipline or Government Intervention?

The creation and backing of the hedge fund LCTM demonstrated the growing use of derivatives in complex and nominally sophisticated trading schemes. Over four years ending in September 1998, Nobel Laureates Myron Scholes and Robert Merton, well-

[716] President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," (April 28, 1999): 1-139.

known for creating the most widely used pricing models for options and futures, led an investment team that convinced a bevy of experienced institutional financial managers to invest in LTCM. However, the trust these large traditional broker-dealers and end-users had in the economists leading LCTM and their risk models was misplaced. By 1998, the fund was heavily leveraged at 100-times assets in stock takeover plays that were unrelated to its core fixed-income arbitrage business. That September, LCTM announced that it had lost 50% of its capital following the default by Russia and the subsequent collapse of global bond markets. As credit markets stumbled, LTCM fell with them and collapsed with over $1.2 trillion in nominal derivative exposure to the market.[717]

Officials at the Federal Reserve Bank of New York and the key counterparties to the LCTM trades judged that the failure of LCTM could lead to failure of the U.S. financial markets. Governmental and financial industry leaders realized that they needed to act in order to avoid the meltdown spreading to the global financial system. Even Alan Greenspan, the foremost apostle of market self-discipline, did not advocate that federal regulators should allow the markets to collapse as the result of a given individual failure. Instead, Greenspan found it perfectly appropriate for the Fed to lead the bankers to a bailout using their own resources. From his perspective this takeover would discipline LCTM by the loss of ownership to its counterparties.[718]

Peter Fisher, Head of Market Operations at the Federal Reserve Bank of New York, then convened a consortium to discuss a bailout of LTCM. The participants were

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[717] Robert Clow, “Hedge Fund Clippings,” *Institutional Investor* 33, no. 1 (January 1999): 51.

[718] Alan Greenspan, “Federal Reserve Role in Facilitating the Private Sector Refinancing of LTCM,” Testimony presented at the Committee on Banking and Financial Services, House of Representatives, Washington DC (October 1, 1998): 1-11.

the heads of the major domestic and foreign commercial and investment bank counterparties to the LCTM trades, along with Richard Grasso, the Head of the NYSE.[719] After intense negotiations, 14 consortium members contributed $3.625 billion to buy out LTCM in return for 90% of the fund.[720]

It was clear to leading bankers, brokers, and policymakers at the time that government intervention was necessary if only to organize the bailout. It was less apparent to them that the intervention in this instance demonstrated a broader need for additional regulation of the OTC derivatives market itself. For example, from the perspective of leading financiers the lessons learned were about individual business practices, not market regulation. That is, the Wall Street titans concluded they needed to provide better due diligence on OTC transactions. One participant in the bailout observed that the implications for institutional investors in hedge funds were not that complicated. “In retrospect, it's hard to imagine how the whole industry just looked at the collateral without looking at the whole picture,” reflected Sanford Weill, co-chairman of Citigroup, one member of the bailout consortium. “The reminder to the financial services industry is, know your customer.”[721]

Federal banking regulators also concluded that additional government regulation was unnecessary. Greenspan later testified that nothing about the bailout of LCTM indicated the need for additional actions to regulate the market itself. He noted that no federal reserve funds were put at risk, or commitments made to the participants in the buy-out. In particular, “The Federal Reserve Bank of New York's efforts were designed

[719] “Blackened Scholes,” *Institutional Investor* 33, no. 1 (January 1999): 83.

[720] Clow, “Hedge Fund Clippings,” 51. Of those in the negotiations only Bear Stearns elected not to contribute.

[721] Clow, “Hedge Fund Clippings,”51.

solely to enhance the probability of an orderly private-sector adjustment, not to dictate the path that adjustment would take."[722]

Acting Comptroller Julie Williams testified that LTCM had lessons to offer the OCC in better bank supervision of individual transactions, but not in supervision of the markets. She noted that, "We are examining these events to discern how bank supervision may be improved to fortify risk management activities in this area." Williams' view appeared to be that LTCM would simply serve as a lesson to banks about effective risk management in counterparty relationships with hedge funds. Her preliminary assessment was that, "The lasting impact of LTCM will be the lessons it teaches about proper management of credit risk, particularly involving leveraged customers, and about the kinds of questions supervisors need to ask the banks."[723]

Williams also continued to argue that derivatives reduced risk despite the evidence from LCTM that the improper use of derivatives could in fact lead to market failures. In particular, regarding the derivatives that transmitted the Russian default to U.S. banks via LTCM, Williams stated, "The OCC believes that, effectively managed, derivatives provide users with flexible risk management tools." She argued that oversight of the market as a whole was unnecessary as long as the end-users were regulated. As a

[722] Greenspan, "Federal Reserve Role in Facilitating the Private Sector Refinancing of LTCM," 1-11.

[723] Julie L. Williams, "Bank Supervision Issues Raised by LTCM," Presented at the Committee on Banking and Financial Services of the U.S. House of Representatives, Washington, DC (October 1, 1998):1. Williams refers here to OCC Banking Circular 277 (BC 277), "Risk Management of Financial Derivatives," issued in October 1993. Its intent was to establish safe and sound practices for managing financial risks, including those arising from derivatives activities.

result, Williams claimed that, "The OCC provides extensive oversight and supervision of derivative usage in national banks." [724]

Finally, Williams made the point that, in her view, it was tractable to regulate the OTC derivatives market via the national banks because of market concentration. Noting that over 95% of the notional value (that is the face value of all contracts prior to being netted out against each other) of derivatives in the banking system were held by eight banks, and 99% in the top 25 banks, she reiterated that, "Over the past six years, the OCC has incorporated into its supervision of national banks the examination of derivative contracts and activities." Williams explained that, in dealing with hedge funds, the OCC expected as a basic principle that banks should secure and maintain sufficient collateral to balance their credit risk. However, in a telling oversight, she did not address how banks were to manage the risks to banks generated by the trading actions of either hedge funds or broker-dealers in derivatives.[725]

Contemporary Policy Conclusions from the LTCM Bailout

Despite the testimony of leading regulators such as Greenspan and Williams, Congress was sufficiently concerned about the near collapse of LCTM that it ordered the President's Working Group on Financial Markets (Working Group) to study the failure of the hedge fund and ascertain any policy lessons learned. The goal of the Working Group's LCTM study was to inform legislation to modernize financial regulations, including the potential to regulate hedge funds and the OTC derivatives market. The resulting report, along with the later report to be issued on OTC derivatives by the Working Group, ensured that by the end of 1998 both the policy community and

[724] Williams, "Bank Supervision Issues Raised by LTCM," 5-7.
[725] Williams, "Bank Supervision Issues Raised by LTCM," 5-7.

Congress understood what policies it would take to regulate OTC derivatives markets. Unfortunately, the report did not advise that its recommended policies be required by law, which left the door open for the policy of self-regulation to continue.[726]

As discussed earlier in the chapter, with the exception of Brooksley Born, the members of the Working Group were committed to market self-discipline as a way to keep U.S. financial markets competitive globally. The impact of this reliance on market discipline is difficult to overstate. It is in fact why the policy community agreed with industry that OTC derivatives need not be brought into a government regulated market, whether under the auspices of the CFTC, SEC, or any other functional regulator.[727]

The Working Group was clear that market self-discipline might lead to failures among private parties. As the report said, "History tells us, however, that creditors, counterparties and investors from time to time misjudge their risks, and that sometimes they become complacent in their risk assessments in an attempt to achieve higher returns." While the members may have been wrong to discount the systemic risk of a particular bank, broker-dealer, insurance firm, or hedge fund failing, their mindset at the time was clearly that market self-discipline was adequate to regulate the OTC derivatives market as a whole.[728]

Given the members' perspective that the OTC derivatives market did not require

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[726] President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," 1-139. However, the report made clear that Chairman Greenspan declined to endorse extending audits to unregulated affiliates, but was willing to defer to the judgement of those with supervisory authority over affiliate financial institutions.

[727] President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," 26-30.

[728] President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," 26-30.

government regulation, it was not surprising that they also concluded that hedge funds did not require direct government oversight.[729] The members assessed that hedge funds used OTC derivatives in fundamentally the same way that the proprietary traders of large commercial and investment banks do. From their perspective the practical implication was that the use of derivatives by hedge funds could be regulated effectively by controls imposed via oversight of broker dealers. Or, as the Working Group report put it, "Although the SEC generally does not regulate hedge funds, it does oversee broker-dealers that may act as creditors of, or counterparties to, these funds."[730]

The report also noted that the associational network of self-regulatory organizations (SRO) had recently been extended in support of the evolving OTC derivatives market. In addition to the Derivatives Policy Group (DPG) framework, under which "the SEC collects additional risk assessment data on credit and market risk related to the OTC derivatives activities of the largest U.S. securities firms," a new SRO was formed in January 1999. This SRO was the Counterparty Risk Management Policy Group (Policy Group). The Policy Group consisted of twelve major, internationally active investment and commercial banks formed to "develop better standards for risk management practices at securities firms and banks in providing credit-based services to major counterparties such as hedge funds." While informed by the need to understand the impact of hedge fund activities, the Policy Group claimed that its roles would be defined

[729] President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," 1.

[730] President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," B-4.

broadly and not limited to providing insights into the impact of hedge funds on the banking members.[731]

The core of the Working Group's policy analysis regarding the failure of LCTM was that the default of even a systemically relevant hedge fund or financial institution need not necessarily destabilize markets if appropriate market mechanisms were allowed to function. They noted the availability of mechanisms that could limit the impact of a default by one of the counterparties and minimize systemic risk to the markets as a whole. These mechanisms were designed to ensure the timely clearing of the derivatives markets. For example, "closeout," was provided under most master agreements, or derivative contracts, for a counterparty to close a failing investment and receive a termination amount from the defaulting party. The members also pointed to "netting" as a risk reduction activity. Netting was the related ability to offset all claims and obligations between two parties into a single transaction. As the Working Group put it, "Netting in particular was intended to limit any "domino effect" resulting from complex interactions among multiple counterparties." The value of both closeout and netting was that they could provide stability in the event of a default, and generally counterparties could expect to enter such agreements legally without fear that they would be overturned by a bankruptcy court.[732]

The Working Group backed up their policy conclusions with superficially compelling data. They noted that at the end of 1998, commercial banks had $4.1 trillion, mutual funds $5 trillion; private pension funds $4.3 trillion; state and local retirement

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[731] President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," F-3.

[732] President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," 30.

funds had $2.3 trillion; insurance companies $3.7 trillion, and hedge funds only $200 - $300 billion in estimated total assets. So, the risk from hedge funds in the OTC derivatives market were expected by policymakers to be subsumed in whatever risk reduction efforts were imposed on the financial industry as a whole. However, this analysis concentrated on the value of trades that had been netted and cleared. This was a surprising oversight given the rationale for the LCTM bailout had been that the hedge fund's uncleared trades were what put the overall markets at risk.[733]

Regardless, it was the members' conclusions about the potential market clearing value of contractually required closeout and netting that drove the later legislative approach in the CFMA.[734] Unfortunately, their analysis was incomplete on this point. In particular, it did not consider the possibility of a failed market for underlying goods. Such a failed market would prevent prices for the related derivative securities from being determined, which in turn would freeze the market and prevent the netting and closeout of counterparty obligations.

This oversight provided the policy support for Congress to write the CFMA to merely recommend rather than require market clearinghouses for timely clearing of transactions to avoid potential bottlenecks during a market breakdown. Unfortunately, neither the leading regulators nor Congress saw fit to require the implementation of these steps. That is, the CFMA as written merely encouraged government regulators to work with industry to establish market clearing procedures rather than establish market governance to require market clearinghouses.

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[733] President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," 1-3.

[734] The CFMA did authorize regulators to impose clearing houses in conjunction with the regulated industry, but it did not require them.

Failure to Apply the Policy Lessons of LCTM

The remaining question raised by the policy response to the failure of LCTM is how the financial services industry, federal regulators, and Congress could all have concluded that government regulation of the OTC market was not necessary? That is, what factors led policymakers to misread the need for government regulation of the OTC derivatives market?

After all, policymakers acknowledged that the LCTM failure demonstrated that hedge funds and their OTC derivative trades could potentially destabilize global financial markets. Manifestly, under the right circumstances the self-regulating oversight structure was incapable of taking timely action to prevent large scale failures. Yet policymakers still concluded that the self-regulatory approach could adequately implement its recommendations on market netting and clearing. In part, as discussed previously, this was grounded in the biased expectation that self-regulation in the OTC derivatives market would best ensure the competitiveness of U.S. financial markets. The rest was explained by a misreading of the role played by governmental regulators in resolving the LCTM crisis, which led policymakers to underestimate and downplay the risks posed by OTC derivatives to global financial markets.

In the first place, the myth that market self-regulation was sufficient was preserved by the fact that neither the Treasury nor the Federal Reserve actually participated financially in the bail-out of LCTM. This allowed policy-makers to consider the rescue of LTCM to be a private bail-out in the long-standing tradition on Wall Street (e.g., JPMorgan's bailout of the stock market in 1907). This view of course discounted the strong leadership role taken by the New York Federal Reserve Bank. Nevertheless, leading regulators made a fundamental policy error in concluding that the LCTM failure did not demonstrate the need for governmental regulation of the OTC markets because only private money was used in the bailout.[735]

The implication of preserving this policy consensus against federal regulatory action was a continued deference to the broker-dealers and end-users in the OTC derivatives market. Rather than forcing counterparties to hold regulatory capital to offset the risk of the OTC transaction not clearing, as some had demanded following the near collapse of LCTM, federal regulators continued to rely on the banks' own risk measurement models, which viewed the use of derivatives as reducing risk, not increasing it. Despite the lessons of LCTM, Greenspan's view remained that market self-discipline remained a more effective way to contain market risks.[736]

Finally, leading regulators believed LCTM was an anomaly. In their view, when the market was working normally, netting and clearing in private transactions would mitigate the risks of large nominal dollar values in the OTC derivatives market. For example, of the nominal $33 trillion in derivative contracts at the end of 1998, of which about $29 trillion were OTC derivatives (reflecting the private preference for customized contracts), the true amount was orders of magnitude less once the contracts were netted

[735] Unlike deposits at commercial banks, the U.S. government did not guarantee the higher risk investments in bonds or securities! As a result, the Federal Reserve Bank of New York provided good offices to broker the deal, but did not participate in the bail-out itself.

[736] Alan Greenspan, "The Development and Expansion of Financial Derivatives," Remarks presented at the Futures Industry Association, Boca Raton, Florida (March 19, 1999): 3. See also Alan Greenspan, "The Current Domestic Economic Situation," Remarks presented at the Mortgage Bankers Association, Washington, D.C. (March 8, 1999): 1-9; Alan Greenspan, "Evolution of Mortgage Markets," Remarks presented at the Conference sponsored by America's Community Bankers on Mortgage Markets and Economic Activity, Washington DC (November 2, 1999): 1-7 in which he discusses new technologies and the ability to create mortgage risk pools as the basis for derivatives that lower risk to individual banking institutions.

out against each other. Although transaction clearance is a dynamic and on-going process, Greenspan suggested that, "On a loan equivalent basis, a reasonably good measure of such credit exposures, U.S. banks' counterparty exposures on such contracts are estimated to have totaled about $325 billion last December." This amounted to less than 6 percent of banks' total assets, which Greenspan felt represented an acceptable level of risk.[737]

The argument that the netted risk was small in comparison to the overall financial markets was a key point that underpinned Greenspan's strong support for market discipline to regulate the OTC derivatives market. He believed that the nominal market value of derivatives was not a useful measure for market risk. Instead, he argued that:

> Notional values are not meaningful measures of the risks associated with derivatives. Indeed, it makes no sense to talk about the market risk of derivatives; such risk can be measured meaningfully only on an overall portfolio basis, taking into account both derivatives and cash market positions, and the offsets between them. [738]

Unfortunately, this argument completely missed the true lesson from LCTM: Financial markets sometimes fail, which as a matter of public policy is exactly when government regulation would be necessary.

However, the Working Group's viewpoint explains why government regulators made no move to establish mandatory exchanges for OTC derivatives even after Congress allowed them to do so. Government regulators were simply not persuaded by the empirical failure of the OTC derivatives market in the case of LCTM that self-regulation was insufficient to prevent market failure. Instead, they believed that institutional end-users and brokers dealers were best equipped to manage their own risk, saw market self-discipline as a way to keep U.S. financial markets competitive, and

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[737] Greenspan, "The Development and Expansion of Financial Derivatives,"1-2.
[738] Greenspan, "The Development and Expansion of Financial Derivatives,"1-2.

concluded that it was unnecessary to require that close-out, netting, and clearing policies be implemented in government regulations. As a result, Congress entered the debates over renewing the Commodity Exchange Act under the influence of a policy community in the grips of a free market bias and a misunderstanding of the overall risk posture faced by the OTC derivatives market.

Modernizing the Commodity Exchange Act for OTC Derivatives

The Commodity Futures Modernization Act of 2000 (CFMA), which revised the Commodity Exchange Act, was shaped by a community wide free-market bias, general misunderstanding of risks from derivatives to the financial markets, and rivalries among the federal regulatory agencies. These factors led to Congress deliberately omitting from the law requirements to make use of known mechanisms for netting and clearing the OTC derivatives market. As a result, the CFMA privileged the global competitiveness of U.S. financial products and institutions over the imposition of safety and soundness measures that could have significantly reduced systemic risk to global financial markets.

Renewal of the CFTC Charter and Legal Certainty for OTC Transactions

Congress, the financial services industry, and the regulatory community as represented by the President's Working Group on Financial Matters (Working Group) generally agreed that the best venue for codifying the regulation, or lack thereof, for OTC derivatives was in revising the Commodity Exchange Act as part of the reauthorization of the Commodity Futures Trade Commission (CFTC). All had agreed to defer consideration of regulating OTC markets beyond the timeframe established for repeal of Glass-Steagall. And, as previously discussed, the timing of the Working Group's report on *Over the Counter Derivatives and the Commodity Exchange Act* was set to coincide with legislation to update the Commodity Exchange Act and renew the charter for the CFTC.

Yet the regulatory community had differing policy goals in mind for revising the Commodity Exchange Act. While all agreed on the need to establish legal certainty for OTC derivative transactions, some disagreed on the method of establishing the validity of those trades. It is useful to bear in mind that the term "legal certainty," was to most a codification of the unregulated state of the OTC derivatives market. The SEC commissioners and Board of Governors of the Federal Reserve in particular agreed with financial industry leaders that the legislation should regulate financial derivatives but clarify that the OTC derivatives market was not subject to the oversight of the CFTC. Chairwoman Born argued instead that legal certainty would be best obtained by formalizing the OTC derivatives market as an exchange regulated by the CFTC.[739]

The SEC's Annette Nazareth represented the views of the broader Working Group in her May 1999 testimony to the Agriculture Committee as it began hearings to reauthorize the CFTC. She observed that that since the CFTC was created in 1974 Congress typically had used the reauthorization process to review the need to revise the

[739] Brooksley Born, "Impact of Technology on Derivatives and Futures Markets." Testimony presented at the Testimony presented at the U.S. House of Representatives Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises of the Committee on Banking and Financial Services, Washington, D.C. (March 25, 1999): 1-4.; Brooksley Born, "Reauthorization of the CFTC," Testimony presented at the U.S. House of Representatives Committee on Agriculture Subcommittee on Risk Management and Specialty Crops, Washington, D.C. (May 18, 1999), 1-5. The CFTC Chair made an interesting side argument. That is, Congress should remove requirement for periodic justification of the CFTC. Born pointed out that, "the Commission will celebrate its 25th anniversary next year, and there can no longer be any doubt that it is necessary and appropriate to have an independent regulatory agency overseeing the nation's futures and option markets." She was rebuffed in this proposal as well as her attempt to have derivatives brought under the CEA.

Commodity Exchange Act and examine the role of the CFTC. Nazareth advocated that the 106th Congress incorporate into that review the question of how to bring OTC derivatives under regulation.[740]

Nazareth and SEC Commissioner Thomas Erickson both cited the need to preserve legal certainty for OTC derivatives as the major issue to be resolved in the CFTC reauthorization. Their view was that the market was evolving newer and better uses of derivatives, and that the goal of Congress and the oversight community should be to provide an appropriate environment for innovation and improvement of derivative instruments. Hence, Nazareth argued, "In order for this market to continue to develop efficiently and effectively, it is essential to provide legal certainty for OTC swaps and other OTC derivative transactions effected between institutional counterparties." And the leadership of the SEC believed the best way to provide legal certainty for participants in this market was to exclude OTC transactions in securities-based swaps from the authority of the CFTC under the Commodity Exchange Act.[741]

The staff of the Board of Governors of the Federal Reserve agreed with the SEC both on the matter of legal certainty and the use of the CFTC reauthorization as a venue to achieve its objectives. As Patrick Parkinson, Associate Director, Division of Research and Statistics explained, legal certainty was necessary for the OTC market to function properly. He testified further that, "The Board believes that modernization of the

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[740] Nazareth, Annette L. "Concerning Reauthorization of The Commodity Futures Trading Commission," Testimony Before the Subcommittee on Risk Management, Research, And Specialty Crops, Committee on Agriculture, United States House of Representatives, Washington, D.C. (May 18, 1999).

[741] Nazareth, "Concerning Reauthorization," May 18, 1999; See also Thomas J. Erickson, "Current Issues Around Reauthorization of the CFTC," Remarks presented at the Chicago Bar Association's Committee on Futures and Derivatives, Chicago, IL (October 19, 1999): 1-4.

(Commodity Exchange Act) is essential. The reauthorization of the (CFTC) offers the best opportunity to make the necessary changes."[742]

As Greenspan indicated previously, the Board strongly preferred market self-discipline to regulate OTC derivatives rather than having control be placed under the CFTC. Parkinson reiterated Greenspan's rationale. The Board remained concerned about global competitiveness, emphasizing that U.S. and world financial institutions were already shifting their derivatives activity overseas, primarily to London. Also, in the Board's view the sorts of protections that the Commodity Exchange Act offered commodities and futures markets were unnecessary for the OTC derivatives market. For example, unlike agricultural prices interest rate swaps were "virtually impossible to manipulate because they are settled in cash, and the cash settlement is based on a rate or price in a highly liquid market with a very large or virtually unlimited deliverable supply." Finally, Parkinson reemphasized that OTC derivative transactions did not require the protection of the CFTC because they were traded among sophisticated private counterparties motivated to look after their own interests.[743]

On the other hand, advocates for CFTC regulation of the OTC derivative markets pointed out that technological improvements and growing experience with OTC trades had already had started industry moving OTC derivative transactions towards

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[742] Patrick M. Parkinson, "Statement before the Subcommittee on Risk Management, Research and Specialty Crops of the Committee on Agriculture, U.S. House of Representatives, May 18, 1999" *Federal Reserve Bulletin* 85, no. 7 (July1999): 484-487.

[743] Parkinson, "Statement before the Subcommittee on Risk Management, Research and Specialty Crops," 485-487; See also Barbara Pedersen Holum, "Reauthorization of the Commodity Exchange Act." Testimony presented at the U.S. House of Representatives Committee on Agriculture Subcommittee on Risk Management, Research and Specialty Crops, Washington, D.C. (August 5, 1999): 1.

"centralized mechanisms for clearing or executing OTC derivatives transactions." Obviously, this trend suggested that the CFTC might have a role in regulating OTC trades to the extent that the transactions were conducted on exchanges, even if they were private exchanges. While this move would clearly create more efficiency in the OTC markets, the financial industry did not want that efficiency at the expense of being subject to CFTC regulation. Or, as Parkinson explained, the development of centralized clearing mechanisms in the U.S. was "impeded by the specter that the (Commodity Exchange Act) might be held to apply to transactions executed or settled through such mechanisms."[744]

Although carefully caveated to apply only to trades made by professional counterparties, Parkinson made clear that, "The Board believes financial derivatives executed or cleared through such centralized mechanisms should nonetheless be excluded from the (Commodity Exchange Act)." That being said, both the SEC and Board recognized that some oversight of these centralized clearinghouses would be required as they grew in importance. Parkinson explained, "Because clearing concentrates and often mutualizes counterparty risks, some type of government oversight of clearing systems may be appropriate. However, it is not obvious that regulation of such clearing facilities under the (Commodity Exchange Act) would always be the best approach."[745]

Instead, Parkinson offered some alternatives to CFTC regulation for Congress to consider. Regarding securities-based derivatives, he noted, "The Board sees no reason why a clearing agency regulated by the Securities and Exchange Commission should not

[744] Parkinson, "Statement before the Subcommittee on Risk Management, Research and Specialty Crops," 487.

[745] Parkinson, "Statement before the Subcommittee on Risk Management, Research and Specialty Crops," 485-487.

be allowed to clear OTC derivatives transactions, especially if it already clears the instruments underlying the derivatives." The Federal Reserve took a similar view towards OTC derivatives traded by banks. Parkinson observed that, "Likewise, if a clearing facility were established in the United States for privately negotiated interest rate or exchange rate contracts between dealers, most of which were banks, oversight by one of the federal banking agencies would seem most appropriate."[746]

The President's Working Group on Financial Markets Report on Derivatives

In November 1999, the same month that GLBA was signed into law by President Clinton, the President's Working Group on Financial Matters (Working Group) published its long-awaited report, *Over-the-Counter Derivatives and the Commodity Exchange Act*. This report reflected the views of the nation's leading financial policymakers, and without doubt was the driving intellectual force behind the CFMA revisions to the Commodity Exchange Act. Demonstrating once again that GLBA and the CFMA needed to be separate for practical reasons, the timing reinforced that both were part of the same financial regulatory policy process.[747]

The Working Group argued that there was no compelling evidence that participants in bilateral swaps would benefit from a central market or exchange regulated by the CFTC. Reflecting the contemporary free market bias, they argued that the counterparties were sophisticated and did not require the same degree of protection as the general public. In addition, the Working Group noted that many of the institutions that made private markets for OTC derivatives were already dealer-brokers, and as such

[746] Parkinson, "Statement before the Subcommittee on Risk Management, Research and Specialty Crops,"485-487.

[747] President's Working Group on Financial Markets, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," (November 9, 1999): 1-35. This report contains an excellent history and summary of the issues and disputes to date.

subject to the SEC, or banks subject to safety and soundness governmental oversight, or futures commissions merchants subject to regulation by the CFTC.[748]

The Working Group also explained their view that derivatives are different from commodity futures. Specifically, they observed that most OTC derivatives were not subject to manipulation because they had specific terms and conditions, were offered in a large and liquid pool of swaps, and were settled in cash rather than the underlying instrument (e.g., the grain, mortgage, or other commodity or security). Moreover, prices set in OTC derivatives transactions did not serve a market price discovery function. Hence, they argued that financial swaps should be exempted from Commodity Exchange Act regulation. However, the Working Group did recommend CFTC oversight be extended to OTC derivatives that involve physical commodities. Their rationale was that CFTC oversight of derivatives based in underlying physical commodities was necessary because of the uncertainty inherent in the underlying assets (e.g., whether a crop of wheat does or does not come in at a specified level.)[749]

After Born's departure in June, the Working Group was unanimous in recommending "that Congress enact legislation to provide a clear basis for the regulation of clearing systems that may develop for OTC derivatives."[750] The phrasing here regarding "may develop" became very important as the basis for Congress not mandating the creation of OTC clearing systems in the CFMA. Additionally, the Working Group

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[748] President's Working Group on Financial Markets, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," 16.

[749] President's Working Group on Financial Markets, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," 17-20. The recommendation to allowing swap terms to be standardized was called out for market efficiency and was not to be considered as creating a market that is subject to CFTC oversight.

[750] CFTC Commissioner David Spears had been acting CFTC Commissioner and de factor member of the President's Working Group on Financial Markets since June 1999.

went to some effort to argue that the establishment of an electronic trading system for any given OTC derivative private market in and of itself should not cause a trading system to be brought under the Commodity Exchange Act, which otherwise had authority over public exchanges.[751]

Finally, the Working Group recommended assigning the regulator or supervisor of any such clearing systems based on the same functional regulatory scheme being considered as part of the repeal of Glass-Steagall. That is, the regulator or supervisor for the underlying commodity or security or financial product would be assigned to regulate the associated for financial OTC derivatives/swaps clearing system. This would be the CFTC for commodities and futures, and the SEC for any security already under the SEC's jurisdiction. It sidestepped other jurisdictional issues by recommending that any institution established for clearing any other OTC derivatives or swaps be organized as a bank or bank holding company under the supervision of the Federal Reserve.[752]

Commentary on the President's Working Group Recommendations

If Congress had hoped to gain some consensus in the policy community through the process of building the Working Group's report on *Over-the-Counter Derivatives and the Commodity Exchange Act*, then the exercise was a success. The White House staff of

[751] President's Working Group on Financial Markets, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act,"17-20. The recommendation to allowing swap terms to be standardized was called out for market efficiency and was not to be considered as creating a market that is subject to CFTC oversight.

[752] President's Working Group on Financial Markets, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," 20-35. The PWG also made recommendations on several specific miscellaneous items, such as how to clarify the Treasury Amendment, a new hybrid instrument rule, and to interpret the "exclusive jurisdiction" clause of the CEA. That is, the PWG recommended that it should not be construed to limit the authority of the SEC or banking regulators. Finally, PWG reiterated its support for close-out, or netting, rules set forth in its report on "Hedge Funds, Leverage, and the Lessons of Long-term Capital Management." These recommendations also contained improved netting procedures in the case of bankruptcy.

the Council of Economic Advisors remarked approvingly of the report:

> Overall, the recommendations are based on the view that the OTC derivatives markets should be allowed to innovate (and) grow without fear of legal uncertainty or increased regulatory burdens. The report does make allowance for the possible future need of regulation as the market evolves and problems arise. The question as to who would regulate this market if the need arises is left open.[753]

Looking towards implementing legislation, Nazareth testified that the SEC explicitly endorsed the Working Group's recommendation to amend the Commodity Exchange Act to "exclude bilateral swap agreements between eligible participants, on a principal to principal basis." Similarly, the SEC concurred in the Working Group's recommendation that Congress "amend the (Commodity Exchange Act) to exclude certain types of electronic trading systems for derivatives." Finally, the SEC supported a compromise that the SEC, Federal Reserve, OCC, and CFTC all get explicit authority to regulate the clearing of OTC derivatives in securities or commodities that would otherwise come under their oversight. In other words, the SEC supported the Working Group's recommendations that neither financial derivative securities nor derivative clearinghouses be subject to the authority of the CFTC.[754]

Federal Reserve Governor Laurence Meyer also testified in support of the Working Group's report. He explained the value of enabling electronic trading systems, which allow for the transfer of data both quickly and accurately. This would have many advantages for OTC derivatives markets, including the ability to update risk management

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[753] John Williams, "Memorandum to Martin Baily with the Council of Economic Advisors Assessment of the Final Draft Report 'Over-the-Counter Derivatives Market and the Commodity Exchange Act,'" The White House (October 27, 1999). Courtesy of the William J. Clinton Presidential Library & Museum.

[754] Annette L. Nazareth, "SEC Testimony: OTC Derivatives Markets," Testimony presented at the House Subcommittee on Risk Management, Research, and Specialty Crops, Committee on Agriculture, Washington, D.C. (February 15, 2000).

systems, manage credit limits, set trading limits, and provide information about the market as well. However, Meyer noted that the development of electronic trading systems for derivatives had been hampered by legal uncertainty about whether or not the Commodity Exchange Act would apply to the foreign exchange market and trading systems for swaps. As a result, Meyer supported the inclusion of voluntary clearinghouses in the CFMA. He observed that, “If the recommendations of the President's Working Group were enacted, this trading system would be excluded from the Commodity Exchange Act, and the legal status of products offered through the service would be clear, likely enhancing its attractiveness.”[755]

Even so, the Working Group’s recommendations left some ambiguity as to when such voluntary clearinghouses might be created. Meyer addressed this issue squarely, arguing that there was no current need to do so. “The challenge for policymakers as these new opportunities are evaluated may well be doing nothing,” he said. “Policymakers no doubt will be tempted to mandate cooperation on the part of market participants in an effort to hasten developments that they believe may reduce risk. In adopting such a course, however, they risk pushing markets and market participants down inefficient and undesirable paths.” What is interesting here is the extent to which the Federal Reserve is prioritizing market competition over market regulation. This may not have been as big an error as the Fed’s failure to provide liquidity during the Great Depression, but it certainly provided the intellectual support for a position that ultimately contributed to a systemic

[755] Laurence H. Meyer, “Strengthening Risk Management for Derivatives,” Remarks presented at the Derivatives Risk Management Symposium, Institute on Law and Financial Services, Fordham University School of Law, New York, NY (February 25, 2000): 1-7.

market failure in 2008.[756]

The only real dissenting voice against the Working Group's recommendations was that of the former CFTC Chairwoman Brooksley Born. In her view, however much knowledgeable observers like Meyer wanted to differentiate among types of exchanges and clearinghouses, OTC derivatives represented a systemic risk for both the banking system and securities markets. Born observed:

> The benefits of functional market oversight apply equally to exchange-traded and OTC derivatives. While the nature of and participants in the OTC derivatives market may warrant a different degree or kind of regulation from the exchange-traded derivatives markets, the size and nature of the OTC market create a potential for systemic risk to the nation's financial markets.[757]

And beyond the risk, she argued, the justification of the unique nature of OTC derivatives for holding them outside CFTC oversight was disappearing. Or, as Born put it, "As OTC market participants seek to clear swaps and express interest in various forms of screen-based trading, the differences between exchange-traded and OTC derivatives markets will be significantly reduced."[758]

Born added that, contrary to the position taken by bank examiners and the SEC, there was no way that that supervision focused on the end-users and dealers would provide sufficient oversight of the market. In the first place, many hedge funds and other highly leveraged institutions were not subject to government oversight in such a regulatory approach. But, most tellingly, she argued that, "An entity-based regulatory approach does not provide oversight of the market generally, which may be particularly dangerous in a market that is currently as opaque as the OTC derivatives market." Her

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[756] Meyer, "Strengthening Risk Management for Derivatives," 1-7.
[757] Born, "Impact of Technology on Derivatives and Futures Markets,"1-4.
[758] Born, "Impact of Technology on Derivatives and Futures Markets,"1-4.

point was that, “Institutional supervisors focus on the trees; market regulators see the forest. Both are needed.”[759]

Interestingly, Leach in 1994 and Born in 1999 both arrived at similar conclusions; namely, that the OTC derivative market should be regulated by as a market rather than individual contractual transactions. However, Leach, influenced by the compromises hammered out under GLBA, later sided with the Working Group that each regulator (SEC, Fed, Treasury, and CFTC) could functionally regulate their respective portions of the financial markets. This functional approach to regulating OTC derivatives may have been the most significant legacy of the debate on financial services modernization on the follow-on update of the Commodity Exchange Act. That is, the policy community concluded that for CFMA the best approach to regulating OTC derivatives was via their dealers and end-users rather than empowering an umbrella regulator for the OTC derivatives market generally. This was almost certainly because the financial community was driven by the importance of functional regulation to the GLBA debates, which led them to miss the importance of establishing regulation at the market level for OTC derivatives.

Passing the Commodity Futures Modernization Act of 2000

Representative Thomas W. Ewing, R-IL chairman of the House Agriculture Subcommittee on Risk Management, Research and Specialty Crops, introduced H.R. 4541 as the Commodities Futures Modernization Act of 2000 on May 25, 2000. This draft legislation was built along the recommendations of the President’s Working Group on Financial Markets report, *Over-the-Counter Derivatives and the Commodity Exchange Act.* The House Agriculture, Banking, and Commerce Committees each held hearings on

[759] Born, “Reauthorization of the CFTC,” 1-5

the bill and by September 6, 2000 each Committee had reported out a different amended version of H.R. 4541. Another Commodity Futures Modernization Act of 2000 was introduced in the Senate on June 8, 2000, as S. 2697. A joint hearing of the Senate Agriculture and Banking Committees was held to consider that bill. The Senate Agriculture Committee reported out an amended version of S. 2697 on August 25, 2000.[760]

Ewing reintroduced the amended Commodity Futures Modernization Act (CFMA) to the House on 14 December 2000 as H.R. 5660, which contained the major provisions already passed in the House as H.R. 4541. These were in Titles I and II, which implemented the unanimous recommendations of the Working Group to provide "regulatory relief for the domestic futures exchanges, legal certainty for over-the-counter products, and allow for the trading of single stock futures." In addition, this version contained language not in the original bill but jointly agreed with the Senate to accommodate the new provisions negotiated by Senator Gramm. Title III provided "guidelines for the SEC's role in regulating swaps," and Title IV excluded identified banking products from the Commodity Exchange Act but included guidelines to determine the proper regulator for hybrid products.[761]

Senator Richard Lugar, R-IN, as Chairman of the Senate Agriculture, Nutrition, and Forestry Committee, then reintroduced the amended CFMA to the Senate as S.3283. The stated objective was to reauthorize the Commodity Exchange Act and CFTC for the

[760] Greenblatt, "Finance: Open Outcry,"1131–33.
[761] Ewing, "The Commodity Futures Modernization Act," E2181-2182.

next five years.[762] However, Lugar also summarized in his remarks the ways the CFMA would reform the Commodity Exchange Act on futures, derivatives, and financial services. First, as noted by virtually all involved, it incorporated the "unanimous recommendations of the President's Working Group on Financial Markets on the proper legal and regulatory treatment of over-the-counter, OTC, derivatives." Second, it codified regulatory relief for the CFTC by removing the single statutory approach to futures.[763] Third, it repealed the Shad-Johnson accord ban on single stock futures. Fourth, it provided certainty that traditional banking products would not be regulated as futures.

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[762] Mark Jickling, "The Enron Loophole," CRS Report for Congress, Washington, D.C.: Congressional Research Service (July 7, 2008): 1-6 includes a discussion of how the CFMA was implemented with three categories of commodities each with different levels of regulation: financial commodities, including derivatives; agricultural commodities; and exempt commodities. The exempt commodities category was later to become known as the "Enron Loophole" after the energy company that went bankrupt trading in these derivatives. Antonia Juhasz, *The Tyranny of Oil* (New York: Harper Collins, 2008): 147-8, claimed, "Without any Congressional Hearing or debate, or public notice, on December 12, 2000 Phil Gramm slipped what would forever referred to as the 'Enron Loophole' into the 262- page Commodity Futures Modernization Act, of which he was the sponsor." While somewhat peripheral given that the issue arose several years after the CFMA was enacted, there are reasons to doubt the attribution of the loophole to Gramm. The attribution was plausible given Gramm's known deregulatory bent and his support for the energy sector in Texas. Conspiracy theorists liked to point to the fact that his wife, a former Chair of the CFTC was on the board of Enron. However, Eric Lipton, "Gramm and the 'Enron Loophole," *New York Times,* November 14, 2008, sec. Business Day reports that in relevant Enron emails, the company discusses ways to get Gramm to allow the bill, which he is cited for holding up for reasons unrelated to the energy provisions. Second, despite the catchy name, the issue of the exception was actually a category of non-financial derivatives that were already excepted from the CEA and CTFC oversight before the CFMA. Finally, this category was already present in the President's Working Group on Financial Markets, "Over-the-Counter Derivatives Markets and the Commodity Exchange Act," (November 9, 1999):16-17, which reads: "The CFTC should, however, retain its current authority to grant exemptions for derivatives involving non-financial commodities, as it did in 1993 for energy products, where exemptions are in the public interest and otherwise consistent with the CEA."

[763] Peter Fitzgerald, "Remarks in Support of CFMA," S11878-9.

Finally, it provided legal certainty for equity swaps by excluding them from the jurisdiction of the CFTC.[764]

On December 20, H.R. 5660 was incorporated by reference into H.R. 4577, the Consolidated Appropriations Act, which was passed by both houses of Congress with a strong bipartisan consensus (292-60 in the House and unanimous consent in the Senate). On December 21, 2000, this omnibus measure, which incorporated the Commodity Futures Modernization Act of 2000 (CFMA), was signed into law by President Clinton on 21 December 2000.[765]

Although not unanimous, the CFMA was widely supported among the financial services industries, Congress, the Administration, and the policy community.[766] Ewing commented that, "I don't think there's any way you can pass a modernization of this type

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[764] Richard Lugar, "Remarks to Introduce the Commodity Futures Modernization Act of 2000," Congressional Record (December 15, 2000): S11924-11926. As an interesting side note, the repeal of the Shad-Johnson Accord might appear to be contrary to the expressed desires of the SEC to preserve it during hearings on CFMA. However, Lugar explained that Congress was working to the PWG's recommendation that the Accord be repealed if the regulatory disparities between futures and securities could be resolved with the CFTC and SEC. Further, in March 2000 the GAO reported there was no longer a reason to keep a ban on single stock futures given that they are traded in foreign markets, in the OTC market, and as options. Gramm and Lugar sent a joint letter requesting a resolution from the SEC and CFTC. And, as Lugar reports, 'On September 14, 2000, the SEC and CFTC reached an agreement on the proper regulatory treatment of these instruments, and we have incorporated this agreement into our legislation."

[765] PL 106-554; Mark Jickling, "The Commodity Futures Modernization Act," Congressional Research Service (February 3, 2003): 1-6.

[766] Lissa L. Broome and Jerry W. Markham, "Banking and Insurance: Before and After the Gramm-Leach-Bliley Act," *Journal of Corporation Law* 25, no. 4 (2000): 723-64; Jerry W. Markham, "Derivative Instruments: Obstacles to Their Regulation in US," in *Swaps and Off-Exchange Derivatives Trading: Law and Regulation,* eds. Eric C. Bettelheim, Helen Parry, and William Rees (London: FT Law & Tax, 1996); Dean Kloner, "The Commodity Futures Modernization Act of 2000," *Securities Regulation Law Journal* 29, no. 3 (2001): 286–97 all highlight contemporary objections to the approach the CFMA took to regulating the OTC derivatives market, which were primarily associated with skepticism about the ability of the SEC and CFTC to work together to regulate the market.

without wide support among the industries and wide support from both sides of the aisle."[767] Leach also spoke in support. "I urge my colleagues to support the legislation before us. Although not perfect, this proposal is far superior to current law, and I urge its adoption."[768] Gramm supported as well but only after ensuring additional measures to protect the energy industry were included.[769]

And, in a rare event, all four of the relevant federal regulatory agencies supported the CFMA as a significant revision to the regulatory division of labor among the financial services industries. Despite Born's continuing view that "the size and nature of the OTC market create a potential for systemic risk to the nation's financial markets," her replacement Chairman William Rainier supported the law.[770] In a joint letter to Congress, placed in the record by Senator Sarbanes, Greenspan, Levitt, Summers, and Rainier said:

> The Members of the President's Working Group on Financial Markets strongly support the Commodities Futures Modernization Act. This important legislation will allow the United States to maintain its competitive position in the over-the-counter derivative markets by providing legal certainty and promoting innovation, transparency and efficiency in our financial markets while maintaining appropriate protections for transactions in non-financial commodities and for small investors.[771]

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[767] Greenblatt, "Finance: Open Outcry,"1131–33.

[768] James A. Leach, "Commodity Futures Modernization Act of 2000," Remarks to the House of Representatives, as reported in the Congressional Record, Washington, D.C. (October 19, 2000): E1877-78.

[769] Phil Gramm, "Remarks at the Introduction of the Commodity Futures Modernization Act of 2000," Congressional Record, S11926-S11927. Accessed December 31, 2017; Gramm, Interview, January 16, 2018. Gramm told me that his influence over the CFMA was always exaggerated by the press. While he participated in the final discussions, he did not have a primary role, unlike GLBA in which he and Leach drove the final result.

[770] Born, "Impact of Technology on Derivatives and Futures Markets." 1-4.

[771] President's Working Group on Financial Markets, "Letter to Senator Paul S. Sarbanes," December 15, 2000, entered into the Congressional Record by Senator Sarbanes (2 January 2001): S11946. Note that by this point Brooksley Born had long been replaced by William Rainier as CFTC Chair.

The Clinton Administration also strongly endorsed the CFMA. Beyond the collective statements of the Working Group, Treasury Secretary Summers, who had replaced Rubin, spoke publicly about the importance and necessity of the bill to maintain the U.S. preeminent role in world finance.[772] Naturally, the professional investment community supported the bill, which was heavily tilted in their favor.[773]

A Missed Opportunity to Incorporate Safety and Soundness

Although the CFMA offered optional safety and soundness mechanisms to help regulate OTC derivatives markets, it deliberately omitted mandatory requirements to close-out and net OTC derivative transactions in order to clear those markets. This was a significant missed opportunity to reduce the systemic risk that OTC derivatives posed to the broader financial markets.

In particular, and really the heart of the CFMA, was the exclusion from CFTC oversight of bilateral transactions of derivative contracts between sophisticated counterparties, on a principal-to-principal basis whether institutions or individuals. The original "Treasury Amendment" also was reaffirmed with the clarification that all transactions in foreign currency and government securities were excluded from CFTC oversight except transactions of futures contracts that were traded on an organized exchange.

Perhaps even more remarkable, Congressional leaders' clearly intended that OTC transactions would explicitly remain unregulated as a market even should they move

[772] Lawrence H. Summers, "Remarks to Securities Industry Association," Washington, D.C. (November 9, 2000): 1-5. Both Summers and President Clinton later tried to disclaim their support for CFMA, but the record shows that they campaigned for it with Congress.

[773] Frederick L. White, "The Commodity Futures Modernization Act of 2000: How It Affects Professional and Institutional Users of Derivatives," *Investment Lawyer* 8, no. 3 (March 2001): 15.

towards electronic trading systems with more standardized terms and conditions. According to Lugar, "We do not intend for these systems to come within the definition of trading facilities."[774] Leach confirmed this interpretation. Addressing the current distinction of OTC derivatives from futures traded on exchanges, he emphasized that even if the contractual and trading terms later became more standardized for OTC derivatives, such "contracts are excluded without regard to whether the parties use a master agreement, confirmation, credit support annex, or other standardized forms to establish the legal, credit, or other terms between them."[775]

Of course, the position of the Working Group was that market discipline would meet the public policy goals of ensuring fair transactions without market manipulation or fraud. But what appeared to have been missed here was the possibility that, despite the best efforts of both involved counterparties and regulatory agencies, some derivative trades created systemic conditions that threatened the entire market. Such a possibility was a sufficient public policy justification to impose government regulation of the markets as a whole. However, this possibility was dismissed by the nation's financial leaders and policy community because of their free market bias and misunderstanding of the systemic risks. The mechanism for a potential market failure was demonstrated by LCTM. Unfortunately, that lesson was set aside by policymakers as an anomaly that could be dismissed as market self-discipline since LCTM was bought out by a private

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[774] Richard Lugar, "Remarks to Introduce the Commodity Futures Modernization Act of 2000," Congressional Record (December 15, 2000): S11924-11926.

[775] James A. Leach, "Commodity Futures Modernization Act of 2000," Remarks to the House of Representatives, as reported in the Congressional Record (Washington, D.C., October 19, 2000): E1877-78,

consortium without public intervention.[776]

Despite the fact that virtually all members of the policy community identified the importance of the OTC derivatives market – Greenspan called it the most important financial development of the decade – the focus was on keeping this market deregulated rather than regulating it appropriately. This was a deliberate policy decision. In the end, the CFMA failed to deal with the externalities created by OTC derivatives markets because of the widely held view that, "The development of the derivatives market has substantially added to the productivity and wealth of our nation." Leading regulatory and Congressional officials attributed this success to the freedom of the OTC private market, and they were reluctant to constrain that economic engine.[777]

This was the historical silence in the financial services modernization debate. Congress missed the opportunity for improved regulation that accommodated the growing complexities and new products, institutions, and financial markets. What the Working Group and Congress alike overlooked was the necessity for ensuring the market itself functions effectively to clear transactions in order to minimize impact of external shocks, as with collapse in price of an underlying asset (e.g., mortgages). Again, this is not simply a retrospective judgement. There was at least one contemporary known mechanism that was both theoretically consistent with market discipline in lieu of market regulation and able to limit the fall out of bad trades to the counterparties involved. That is, either a law or regulation could have required both a mandate to net trades and clear

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[776] It was also later demonstrated by the Enron collapse, but this was years later and resulted in a closing of the "Enron Loophole" in the Farm Bill (P.L. 110-234). This law established a more stringent regulatory regime for the electronic trading facilities used for setting energy prices.

[777] Lugar, "Remarks to Introduce the Commodity Futures Modernization Act of 2000," S11924-11926.

them on a routine, perhaps daily, basis.[778]

This mechanism was well understood at the time and technologically feasible. It might have been done by requiring the implementation of electronic clearing houses in which the risk of trades would be mutualized by all the dealers guaranteeing the derivative contracts and collectively assuming the risk of default. Many contemporary observers, including the Working Group members, believed that such clearing mechanisms, accompanied by appropriate rules, would reduce systemic risk; that is, the "risk that the failure of a single large swap dealer would have repercussions throughout the financial system."[779]

The CFMA came close to implementing this approach. Or, as Lugar put it, "Another important recommendation of the President's Working Group was to authorize futures clearing facilities to clear OTC derivatives in an effort to lessen systemic risk and this bill incorporates this finding."[780] Unfortunately, in the end the CFMA only authorized clearing facilities without requiring them.[781] As the Congressional Research Service reported, "The CFMA provides for the establishment of clearing houses for OTC derivatives, establishes certain regulatory requirements for them, and allows their

[778] Another way would have been to require better information be provided to the public and federal regulators about both OTC trades individually and the hedge funds that were often counterparties to the trades. C.f. CRS Report RS20394, "The Hedge Fund Disclosure Act: Analysis of H.R. 2924." The 106 Congress considered but did not pass legislation that would have required the largest hedge funds to file quarterly reports on the size and riskiness of their market positions with the Federal Reserve.

[779] Jickling, "The Commodity Futures Modernization Act," 1-6.

[780] Lugar, "Remarks to Introduce the Commodity Futures Modernization Act of 2000," S11924-11926.

[781] Gramm, Interview, January 16, 2018. Senator Gramm firmly believed that granting the regulators discretion to establish the clearing houses was sufficient. He saw no reason to force the issue and substitute the judgement of Congress for expert in industry and regulatory agencies with a new market for such dynamic instruments.

operators to choose whether to be regulated by the CFTC, the SEC, or a banking regulator." Of course, we now know that in the years after CFMA and leading up to the financial crisis in 2008, neither exchanges nor clearinghouses were implemented to replace the private trading structure for OTC derivatives in the U.S. in any meaningful way.[782]

Chapter 5 Conclusion: Assessing the Commodity Futures Modernization Act

This chapter has addressed the factors that shaped the Commodity Futures Modernization Act of 2000 (CFMA) and separated the issue of financial modernization from repeal of Glass-Steagall in the Gramm Leach Bliley Act of 1999 (GLBA). The end result was that Congress deliberately omitted regulatory requirements that could have reduced the systemic risk to traditional U.S. financial markets from relatively new instruments such as hedge funds, derivatives, and over-the counter (OTC) markets.

Several institutional factors shaped the legislative debate over regulating OTC derivatives market. These included a path dependence on depression era laws and institutions as well as a fractured policy process. Another key factor was the agency that Congress granted leading policymakers such as Alan Greenspan and Arthur Levitt, who were strongly influenced by the free market bias inherent in the evolving neoliberal ideological consensus. This was reflected in a mindset that market discipline

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[782] Ben Bernanke, "Clearinghouses, Financial Stability, and Financial Reform." Speech, At the 2011 Financial Markets Conference, Stone Mountain, Georgia, April 4, 2011; Jickling, "The Commodity Futures Modernization Act," 4. See also John Dooley and Hamish Risk, "Fed Calls in Banks on Derivatives Paperwork Backlog." *Bloomberg*, September 13, 2005. The New York Federal Reserve bank leadership called the 14 major derivatives counterparties to cajole them to improve the clearing times for OTC derivatives, which stood at 13 days. This article quotes Alistair Milne, who observed that "Banks have been too focused on their own profit interests and in grabbing a share of the rapidly expanding market and haven't focused on operational issues."

supplemented by associational self-regulatory organizations was adequate for public policy purposes, and that functional, entity-oriented regulators were best suited to regulate the derivatives trade among their associated financial institutions.

Moreover, despite the demonstrated inadequacies of self-regulation in the case of the LCTM hedge fund failure, policymakers consistently misunderstood the nature of the systemic risk that OTC derivative transactions posed to the overall financial markets. Finally, the 1990s were a time when the secular trends towards securitization and financialization appeared to hold the keys to the success of the U.S. as the world leader in financial market innovation. As a result, policymakers privileged the global competitiveness of U.S. financial markets over the safety and soundness of OTC derivatives markets.

CFMA ultimately achieved its objective of establishing legal certainty for the OTC derivatives market. But it did so by deliberately omitting requirements to implement mandatory electronic trading clearinghouses, which could have required the netting and close out of derivatives transactions on a routine basis. The failure to do so was a nod to the financial industry, which preferred a lack of accountability under the guise of market self-discipline. However, this left the OTC derivatives market facing the risk of trillions in open trades at any given point, which could cause a failure of the OTC derivatives markets should the product markets underlying the swaps fail. In other words, a historic opportunity was missed to provide improved regulations to address the systemic risk posed by OTC derivatives markets, which played a role in the 2008 financial crisis.

Regarding the story of financial services modernization, this chapter demonstrates that there was little practical expectation that the legislative efforts to repeal Glass-

Steagall were going to comprehensively reform the oversight of financial markets. As discussed, there were too many factors that were driving the issues associated with hedge funds, private derivatives contracts, and OTC derivatives markets into a separate legislative debate over reform of the Commodity Exchange Act and renewal of the CFTC charter. However, it is also clear that the story of the CFMA and GLBA must be told together in order to understand why both failed to address important safety and soundness issues regarding modern financial markets in general and OTC derivatives in particular.

Chapter 6: Epilog – The Limits of Financial Modernization

This narrative is a policy history of financial modernization as seen through the formulation and passage of the Gramm Leach Bliley Act of 1999 (GLBA) and the Commodity Futures Modernization Act of 2000 CFMA. While scholars and pundits alike have at times criticized each law, especially GLBA for its repeal of Glass-Steagall, this dissertation makes clear that they had a significantly less deregulatory impact on the U.S. financial system than often ascribed by critics. Another insight that emerged from the research is that both GLBA and CFMA were more important for what they did not do than what they did. In particular, the 106th Congress represented a historic missed opportunity to ensure the safety and soundness of the U.S. financial system by imposing specific regulations on new financial institutions, products, and markets, such as hedge funds and the OTC derivatives market. Hence the story would not be complete without an assessment of the impact that financial modernization had on the stability of the financial system in the subsequent financial crisis of 2008.

While GLBA was nominally deregulatory because it eliminated the restrictions on affiliation among commercial banking, securities, and insurance, one must bear in mind that those restrictions had long since fallen into disuse. As a practical matter, GLBA reasserted Congressional authority over the financial system by incorporating recent regulatory practice and judicial decisions. If anything, legislation to repeal the Glass-Steagall Act was overdue, given that Congress had previously disposed of other key facets of the New Deal financial regulatory structure such as interest rate and geographic controls. As Wayne Abernathy noted, “GLBA codified changes in the market that had been approved haphazardly via regulatory and judicial decisions. The law needed to catch up to the market in order to reduce friction in the marketplace, set an environment for innovation, and allow U.S. financial sector to continue to lead the world."[783] In that sense, GLBA merely captured the shifting ideological consensus towards neoliberalism and market self-regulation that was occurring in response to the evolving globally competitive financial markets of the late 1990s.[784]

However, in analyzing the impact of GLBA historically it is useful to consider why GLBA was so narrowly scoped that in the end the law was of limited deregulatory impact. The key issues that framed GLBA to just focus on the repeal of Glass-Steagall were driven by several interrelated themes. In the first place, the policy process reflected the fragmented nature of American politics. That is, the complexities of the political process constrained policymakers to focus on repealing Glass-Steagall and generally prevented them from straying too far from that goal. As a result, concerns about regulating innovative new products and markets such as OTC derivatives were pushed to the CFMA. Even then, Congress did not impose important safety and soundness regulations known to be effective because it was advised by leading regulators who sought to enhance the global competitiveness of U.S. markets but misunderstood the systemic risks posed by OTC derivatives market structure.

[783] Wayne Abernathy, Interview, retained by Timothy J. Galpin, January 23, 2018.

[784] It is important to bear in mind that contemporary observers considered GLBA to be an important milestone in restoring the competitiveness of the U.S. financial system. See William Jefferson Clinton, "Draft Statement by the President on Signing the Gramm Leach Bliley Act," The White House, November 8, 1999, Courtesy of the William J. Clinton Presidential Library & Museum, who cited a Treasury estimate that the law would create efficiencies among U.S. financial institutions worth $15 billion to consumers. See also Dan Zielinski, "The Onset of a New Financial Era," *Insurance Advocate* 110, no. 44 (November 6, 1999): 3. AIA's Zielinski claimed, "By any measure, this legislation will be long remembered as a historic achievement and one that will bring great benefit to consumers, the U.S. financial services industry and the national economy."

Regarding GLBA, the Glass-Steagall restrictions were successively undermined by a series of regulatory and judicial decisions from the 1980s on. These changes came in response to the Depression-era financial regulatory structure failing under the weight of massive inflation, high interest rates, global competition from universal banks, and a hidden banking crisis in the 1970s and 1980s. Combined with a secular financialization trend that affected the entire economy, the evolution of financial markets, technologies, and products was reflected a free market bias that permeated the financial services regulatory community. Successive Federal Reserve Chairmen and Comptrollers of the Currency were persuaded to provide regulatory relief designed to make the U.S. banking system more globally competitive. Both the securities and insurance industries fought the bankers in regulatory hearings, in court, and in Congress. However, throughout the 1990s, the large commercial bankers were successful in convincing both federal bank supervisors and the courts to undermine the law. Absent congressional action, the courts applied the *Chevron* doctrine to grant deference to the leading regulator's interpretation of the law, eventually rendering the Glass-Steagall separations moot.[785]

While the insurance and securities industries were unable to restrain bankers through regulatory actions or the courts, they were able to lobby successfully to prevent actual legislative repeal until they were able to establish a stronger bargaining position.[786] Beginning in 1988, Congress repeatedly considered but failed to pass financial

[785] Larry P. LaRocco, Interviewed by Steve Cocheo, "Business as Usual for the Section 20 Crowd? Yes and No," *ABA Banking Journal* 92, No. 1 (January 2000): 47-50.

[786] William Jefferson Clinton, "Transcript of Remarks at the Signing of the Financial Modernization Bill," Washington, D.C., November 12, 1999. President Clinton acknowledged House Commerce Chairman Thomas Bliley, R-VA for his efforts on behalf of the insurance and securities industries. See also James Q. Wilson, "The Politics of Regulation," In *The Politics of Regulation,* Ed. James Q. Wilson (New York: Basic Books, 1980), 357-390.

modernization legislation. It became clear that no repeal of Glass-Steagall was possible until the commercial banking, insurance, and securities industries were able to come to common agreement. In fact, American Banking Association chief lobbyist Edward Yingling believed the difference between the success of GLBA in 1999 and past legislative efforts was that all the industries went to the congressional leadership together. The Congressional response was, "This is different. You guys are all together; you're all telling us you want the bill."[787]

Each side in the GLBA debate originally had very different interests, and much of the legislative wrangling was about narrowing the scope so that each industry saw value in the law. The bank, security, and insurance businesses were finally willing to come together to Congress on a common front only after the insurance and securities companies were successfully able to deploy a strategy leveraging unitary thrifts to pressure bankers to a negotiation on somewhat equal terms. As a result, GLBA was a win for big players in the financial services industries. Large banks codified their gains, exemplified by the ability of Citigroup to forego unraveling its merger, and closed the unitary thrift loophole. The insurance and securities halted the piecemeal dismantling of their industry firewalls by regulatory action, gained equal footing with banks in financial services, and were able to preserve a beneficial regulatory structure.[788]

[787] Edward Yingling, Interview by Steve Cocheo and William Streeter, "The Making of a Law," *ABA Banking Journal* 91, No. 12 (December 1999): 20-24.

[788] James A. Leach, E-mail to Timothy J. Galpin, November 20, 2017. According to Leach, an underappreciated aspect of the law was that it imposed regulation where none previously existed. For example, bankers' insurance activities had to meet state insurance industry standards, and insurance companies' banking activities were now subject to oversight by one or more of the bank examiners. Whether this made GLBA more regulatory or deregulatory was less important to Leach than that it provided better regulation that the status quo ante.

On this final point, the quid pro quo demanded by the securities and insurance industries for repeal was functional regulation, which distributed oversight of the financial services industries by the nature of the underlying product (e.g., banking, securities, or insurance). The practical implication of this political compromise was that all of the regulatory agencies retained their political power base. Yet no one agency had the mandate or resources to monitor the financial system as a whole. Even more telling, other than allowing the affiliation of banking, securities, and insurance businesses, no safety and soundness regulations were actually changed in the law. Instead, it was left to the existing regulatory agencies to implement the new legal structure as they saw fit, which in the case of securities and insurance leveraged a significant self-regulatory component sometimes labeled associationalism. In other words, the functional regulation compromise necessary to pass the law left the status quo regulatory structure intact, which minimized GLBA's deregulatory impact.

The narrow focus of GLBA on repeal of Glass-Steagall was also strongly influenced by the focus the financial policy community placed on the Depression-era financial regulatory structure. In the first place, considered over time it was apparent that the financial regulatory structure was being dismantled piecemeal as driven by economic conditions. For example, the high interest rates and inflation from the late 1960s through early1980s led first to the elimination of interest rate controls and then to removal of geographic controls a decade later. Given that the ideological consensus shifted in the 1990s to a neoliberal focus on financialization and global competitiveness rather than controlling the risk and moral hazard to banks, the next logical step was to repeal Glass-Steagall. Policymakers were simply following the recent pattern by excluding broader reforms to focus on one deregulatory step at a time. History after all suggested that there would be time later to address other issues, such as bankruptcy reform or regulating new financial products such as derivatives.

Aside from this sequential approach, which led to the derivatives issue being pushed to CFMA, the second important aspect of the Depression-era focus of policymakers was that it incorrectly framed the risks to modern financial institutions. Key policymakers such as Greenspan and Rubin continued to focus on the safety and soundness of banks from the perspective of protecting the deposit insurance fund rather than considering what new risks needed to be mitigated. For example, instead of considering how to mitigate the systemic risks of innovations such as OTC derivatives during the GLBA debates, they focused on the impact of holding company corporate structure versus the bank operating subsidiary model on the federal safety net for banks, which was developed in response to the banking panics of the 1930s.

Furthermore, the path dependent efforts by federal regulators to preserve their authorities under the Depression-era financial regulatory framework led policymakers to mischaracterize the risks to the financial system when they were considering the CFMA. That is, because they provided oversight of individual banks, broker-dealers, and insurers, regulators focused their risk management oversight at the business entity level rather than on financial markets as a whole. Combined with a free market bias towards self-regulation, this approach led directly to the erroneous conclusion that it was unnecessary for CFMA to regulate the overall OTC derivatives market.

In practice, as financial markets and instruments became increasingly complex, leading regulators at the SEC, federal bank supervisory agencies, and state insurance commissioners defaulted to managing risk by allowing financial institutions to model their own required capital reserves to cover risks from individual trades. Then in the 1990s, large financial institutions increasingly turned to derivatives to manage their risks, which their models reflected as a reduced need for capital reserves. The key flaw here was that these models did not address systemic risks that derivatives could pose to the financial markets as a whole if their underlying product markets failed. This of course is what happened in 2008 when the derivatives market failed in the face of the inability to price swaps based in mortgage backed securities as housing prices began to fall.

Even though these long-term trends resulted in GLBA being narrowly defined, it was not a foregone conclusion that financial modernization would not include effective regulation of U.S. financial markets. A review of the parallel evolution of CFMA with GLBA demonstrates that the policy-makers and legislators of the 106th Congress had before them the necessary information to impose effective governmental supervision over hedge funds and the OTC derivatives market but deliberately failed to do so. In other words, the 106th Congress represented a historic missed opportunity to implement public policies to ensure the safety and soundness of the U.S. banking system and to mitigate the systemic risks represented by the modern financial services markets. In order to see how that played out, we must next examine the laws in the context of the 2008 financial crisis.

GLBA and the Financial Crisis of 2008

Many still attempt to place the blame for the financial crisis of 2008 on the repeal of Glass-Steagall.[789] The basic argument is that GLBA set the conditions that caused the

[789] Andrew Ross Sorkin, *Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System from Crisis--and Themselves* (New York: Viking, 2009); Gretchen Morgenson and Joshua Rosner, *Reckless Endangerment:*

eventual market collapse. This direct causal linkage is almost certainly wrong.[790] It may be more defensible to say that GLBA was representative of a deregulatory mindset, which eventually resulted in the 2008 crisis.[791] Regardless, this fairly broad journalistic and popular criticism was lent some credence by the support of former Federal Reserve Chairman Paul Volcker, who in the wake of the 2008 crisis called for a partial reinstatement of Glass-Steagall in the form of the "Volcker Rule."[792]

Those who link GLBA's repeal of Glass-Steagall causally to the 2008 crisis because of its deregulatory impact are focused on the wrong issue. While GLBA partially

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How Outsized Ambition, Greed, and Corruption Led to Economic Armageddon, 1st ed. (New York: Times Books/ Henry Holt and Co, 201); and James Rickards, "Repeal of Glass-Steagall Caused the Financial Crisis," U.S. News Economic Intelligence, blog, 12 August 2012 are representative. Rickards became a vocal critic of GLBA in the aftermath of the market meltdown. He once said, albeit with some hyperbole, "In 1999, Democrats led by President Bill Clinton and Republicans led by Sen. Phil Gramm joined forces to repeal Glass–Steagall at the behest of the big banks. What happened over the next eight years was an almost exact replay of the Roaring Twenties."

[790] Victoria Geyfman, "Commercial Banks and Securities Underwriting: The Impact on Risk, Return, and Diversification," *Journal of the Northeastern Association of Business, Economics & Technology* 16, no. 1 (2010): 1–8; Gary Gorton and Nicholas Souleles, "Special Purpose Vehicles and Securitization," in *The Risks of Financial Institutions*, eds. Mark Carey and Rene Stulz (Chicago: University of Chicago Press, 2007): 549–97 are representative of economic and financial analyses of the value to financial institutions of GLBA. Similar to studies about the Pecora Commission, they show that holding companies that expanded into securities activities after GLBA were more diversified and less likely to fail relative to their stand-alone commercial banking and securities underwriting subsidiaries. Other often criticized financial activities such as off-balance sheet financing allowed sponsoring firms to finance themselves by separating control rights over assets from financing and protect those assets from bankruptcy. These arguments are not conclusive by any means, and are offered to raise the issue of actual risk reduction.

[791] David Moss, "Reversing the Null: Regulation, Deregulation, and the Power of Ideas," *Working Papers -- Harvard Business School Division of Research*, October 2010, 1–14.

[792] William L. Silber, *Volcker: The Triumph of Persistence* (New York: Bloomsbury Press, 2012). The "Volcker Rule" as part of the Dodd-Frank Act made it illegal for banks to make certain types of trades with their own funds, and imposed limitations on the relationship banks could have with hedge funds and private equity investments.

repealed Glass-Steagall, the functional regulation compromise meant that the institutional mix of regulators and their rule sets remained the same. Furthermore, GLBA merely codified administrative and judicial steps already reflected in the markets. In fact, to the extent that GLBA affected financial regulatory authorities, it actually "added to, rather than subtracted from, federal oversight authority over fast changing markets."[793]

Regarding the impact of GLBA itself, the data does not support a conclusion that repealing Glass-Steagall led to any of the institutional failures during the financial crisis of 2008. [794] For example, there is no evidence that any institution failed or put itself at any significant systemic risk by the securities industry doing too much commercial banking, or underwriting too much insurance. Neither is there evidence that the insurance industry undertook too much commercial or investment banking. Finally, commercial banks did not get into any specific trouble by engaging in activities that they would not have been allowed to do before GLBA.[795] In other words, according to Raymond Natter, a former Deputy Counsel at OCC, "There is simply no support for the contention that but for the repeal of Glass-Steagall companies would not be considered too big to fail."[796]

Indeed, GLBA was for the most part not directly relevant to the activities that did appear to get the major financial institutions in trouble in the 2008 crisis. For example, before GLBA commercial banks, investment banks, and insurance companies already

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[793] James A. Leach, Working Papers (2009/2010): 1.

[794] Peter J. Wallison, "Deregulation and the Financial Crisis: Another Urban Myth," *Financial Services Outlook*, American Enterprises Institute, October 2009.

[795] James A. Leach, Working Papers (2009/2010): 5.

[796] Raymond Natter, "Deregulation and the Financial Crisis," *Our Perspectives: Commentary on the Economy and Regulatory Policies Affecting Financial Companies*, (August 2012): 4. The comment on LCTM is not quite right, since it was not a government bailout, but certainly the Federal Reserve Bank of New York led the talks for the private bailout.

were allowed to deal in derivatives in general, and mortgaged backed securities in particular. This is important because it meant that these institutions were linked together as counterparties to derivatives contracts long before GLBA allowed them to affiliate. In fact, the trend of securitizing mortgage loans had a part of banking since the development of mortgage-backed securities in the 1970s. As a result, Natter observed, "There is no connection between the repeal of Glass-Steagall and subprime lending or the securitization of subprime loans."[797]

Similarly, GLBA was not responsible for the securities industry in general, or the ability of some of the key institutions such as AIG, Lehman, and Bear Stearns, or Fannie Mae and Freddie Mac, taking on the levels of institutional risk that they did in the early 2000s.[798] Although it would be the topic of a separate paper, this phenomenon had more to do with business decisions made after an international financial accord was reached in

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[797] Natter, "Deregulation and the Financial Crisis," 3-4.

[798] James A. Leach, Working Papers (2009/2010): 5. After the turn of the 21st century, there were further missteps that are beyond this scope of inquiry. For example, international standards set at Basel II with the active support of the U.S. banking policy community, including the Federal Reserve, enabled the large U.S. banks to embark on higher leveraged positions based on new risk models, set by the banks themselves, in lieu of the former capital ratio standards. In 2004, the SEC authorized the largest investment banks to similarly increase their leverage and then failed to provide adequate oversight of their investment practices as the risks inherent in leverage were increased. Also, driven by international standards requiring federal regulatory oversight of U.S. financial institutions conducting businesses internationally, the AIG branch in London responsible for derivatives was given to the Office of Thrift Supervision. Although OTS shared responsibility with the New York Insurance Department since AIG was also, and arguably primarily, an insurance company, neither agency was well equipped to provide oversight of credit default swaps, in which AIG made the market by providing reinsurance for the OTC positions held by Wall Street banks. Other moves were more or less in defiance of regulatory tradition, as when in 2000 the OCC gave national banks permission to employ equities as part of their derivatives strategy without normal public or Congressional input. Finally, in the aftermath of 9/11, law enforcement of fraud in the financial arena, notably by the FBI, Treasury and the Federal Reserve, appeared to have taken a second place to exploding concerns about rooting out the finances of terrorists and anti-terrorism security measures.

2004. Basel II, as it was known, changed capital reserve standards, reducing them for some nominally safer assets like mortgages and raising them for potentially riskier assets. As we have seen, the financial community assessed that it could accept lower capital reserves, and higher institutional risks, because derivatives were incorrectly assessed to lower overall systemic risks.[799]

Finally, GLBA was silent on a significant failure in housing policy that some contend was related to the financial crisis of 2008. Peter Wallison argued that, "The *sine qua non* of the financial crisis was the U.S. Government housing policy, which led to the creation of 27 million subprime and other risky loans – half of all mortgages in the United States – which were ready to default as soon as the massive 2007-2008 housing bubble began to deflate."[800]

In actuality, GLBA likely mitigated the worst effects of the financial crisis by permitting solvent commercial banks to buy out and recapitalized failed investment banks. For example, the regulatory framework under GLBA allowed JPMorgan Chase to take over the investment bank Bear Stearns, while Bank of America was able to absorb Merrill Lynch. Further, Barclays was able to take over the structural and operating assets of Lehman Brothers once others had stepped in to assume its losing investment positions. Later, under terms of the Troubled Assets Recovery Program (TARP) bail-out of Wall

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[799] Daniel K. Tarullo, *Banking on Basel: The Future of International Financial Regulation* (Washington, D.C.: Peterson Institute for International Economics, 2008), 5-7; Natter, "Deregulation and the Financial Crisis," 5.

[800] Peter Wallison, Dissent from *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (New York, NY: Public Affairs, 2011), 443-444. While the *Inquiry* Report was meant to be the final word, the Commissioners only approved it 6 to 4. One of the *Inquiry* Commissioners, who I spoke with on condition of anonymity, told me that Wallison's data was in error, but I was unable to substantiate the argument.

Street, both Morgan Stanley and Goldman Sachs were reorganized as holding companies. Thus, enabled by GLBA, the financial crisis ultimately resulted in all the major American investment banks becoming subject to holding company oversight, capital requirements, and limitations.[801]

This dissertation has demonstrated that GLBA represented a series of compromise policies that were necessary in order to obtain the underlying policy goal of repealing Glass-Steagall. And yet one measure of the success of the functional regulatory structure that GLBA enacted is that it has proven to be remarkably enduring. For example, Wayne Abernathy observed that even Dodd-Frank, the financial regulation passed in response to the 2008 financial crisis, retained the GLBA regulatory structure.[802]

On the other hand, *The Financial Crisis Inquiry Report (Inquiry),* which was meant to be the definitive word on the causes of the 2008 crisis and subsequent recession, did indict Congress for its failures with the CFMA regarding regulation of the OTC derivatives market. In particular, the *Inquiry* concluded that, “The enactment of legislation in 2000 to ban the regulation by both the federal and state governments of over-the-counter (OTC) derivatives was a key turning point in the march towards the financial crisis.”[803] Although correct in principle, the *Inquiry* is factually inaccurate in this judgment. That is, the CFMA did not ban the regulation of OTC derivatives. Rather it exempted derivatives from regulation under the CFTC, not from any regulation at all. Instead, it placed derivatives in the GLBA functional regulatory framework, which

[801] James A. Leach, Working Papers (2009/2010): 5-6.

[802] Abernathy, Interview, January 23, 2018.

[803] National Commission on the Causes of the Financial and Economic Crisis in the United States*,* Conclusions of *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (New York, NY: Public Affairs, 2011), xxiv

concentrated oversight on the counterparties rather than at the market level. That is to say, the banking supervisors, SEC, and to a lesser extent state insurance commissioners were left to oversee OTC derivative transactions rather than the OTC derivatives market.[804]

The key shortfall, to the extent that the *Inquiry's* indictment is valid, was that Congress wrote the CFMA to allow but did require the establishment of exchanges to clear, net, and close-out derivative transactions on a routine basis.[805] Picking up on this point, Leach assigns the responsibility for the derivatives market meltdown to federal regulators. That is, he argued Congress did its job in passing the CFMA, which put in place a framework for "mutualization of derivatives counterparty risk, supervision of derivatives clearing, and for resolution and clearing of derivatives contracts involving insolvent entities." Leach may be overly forgiving and somewhat self-serving on this point. Congress certainly had the opportunity to direct the clearinghouses be established

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[804] Laurence H. Meyer, "Issues in Financial Modernization," Remarks presented at the Conference on Financial Structure, the Jerome Levy Economics Institute of Bard College, Annandale-on-Hudson, New York (April 10, 1997): 1-8. Prior to GLBA, Meyer argued that the regulation of OTC derivatives at the institutional level would be difficult. This is another example of a senior policymaker overlooking misgivings about risks in the OTC derivatives market structure in order to bolster the global competitiveness of U.S. financial markets.

[805] National Commission, *The Financial Crisis Inquiry Report,* xxv. The *Inquiry* claims that OTC derivatives contributed to the crisis in three ways: 1) credit default swaps (CDS) fueled the mortgage securitization pipeline. Companies sold derivatives (e.g., $79 billion at AIG alone) as protection against default or decline in value of CDS backed by risky mortgages; 2) synthetic collateralized debt obligations (CDOs) were merely bets on the performance of real CDS, which amplified losses from the collapse of housing prices by allowing multiple bets on the same securities (e.g., Goldman Sachs sold $73 billion in synthetic CDOs from 2004-2007, of 3400 mortgages referenced in CDOs, at least 610 were referenced twice); 3) AIG, lightly regulated at the federal level by the OTS, was not "required to put aside capital reserves as a cushion for the protection it was selling."

instead of merely authorizing them.[806] Indeed, one of the main points of this dissertation is that the failure to require electronic trading to provide transparency and clear OTC derivative markets was the essential flaw of the paired legislation of GLBA and the CFMA. However, there is no doubt that the CFTC, Treasury, SEC, and Federal Reserve also all failed to move in a timely fashion to create a swaps market clearing facility for OTC derivatives once given the authority to do so by CFMA. Indeed, no mandatory market clearinghouse for derivative transactions was formally established until the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[807]

Another major contributing cause identified by the *Inquiry* was failure of corporate governance. This charge appeared to have two major components. First, the commercial and investment banks alike "took on enormous exposures in acquiring and supporting subprime lenders and creating, packaging, repackaging, and selling trillions of dollars in mortgage-related securities, including synthetic financial products." Second,

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[806] James A. Leach, Working Papers (2009/2010): 12-13. According to Leach, "The greatest challenge in derivatives markets is to get a handle on individually tailored products sold in multi-country, multi-party markets." He believed that the creation of a clearing process for OTC derivatives was of paramount importance to create stability in the markets. In the first place, it allowed for swaps, including credit default derivatives, to be standardized and regulated. Second, and as important, it allowed costs to be accounted for and the risks managed. For example, without a clearing process, the value of derivatives transactions had to be considered at face value, which in notional terms was greater than the combined GDP of the entire world. However, with a clearing process the individual swaps could be netted out, or cross-discounted with the positions of the counterparties. This would reduce nominal liability by two orders of magnitude.

[807] PL 111-203, 124 USC 1376-2223 was passed on July 21, 2010, two years after the crisis. James A. Leach, Working Papers (2009/2010): 13; Bernanke, "Clearinghouses, Financial Stability, and Financial Reform," Speech presented at the 2011 Financial Markets Conference, Stone Mountain, Georgia, April 4, 2011 reports that Section 7 of Dodd-Frank incorporated a mandatory clearing policy for standardized derivatives. Before that, multiparty derivatives clearinghouses were not formally established until 2009, when the Federal Reserve chartered a special purpose clearing bank for large institutions.

the investment banks in particular were operating on irresponsible margins of capital reserves. The *Inquiry* noted that, “In 2007, the five major investment banks – Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley – had operating with leverage ratios as high as 40 to 1. For the GSEs, Fannie and Freddie had a combined leverage ratio at 75 to 1.”[808]

While these observations point to governance and risk management issues, these failures should not be attributed to either GLBA or the CFMA. Instead, once again we must look to poor performance on the part of the bank examiners and SEC, who fundamentally misunderstood the systemic risk to financial markets from the innovative institutions and products that were developed over this period. Or, as the *Inquiry* acknowledges, “They were hampered because they did not have a clear grasp of the financial system they were overseeing…This was in no small measure due to the lack of transparency in key markets. They thought risk had been diversified when it had been concentrated.”[809]

Regardless, there has developed a significant retrospective literature, some self-justifying and some analytical, to explain the crisis that has set the tone for much of the scholarly debate as well. As we have seen, administration and congressional leaders were aware of the risks, but made poor public policy choices based on a flawed understanding of the current state of the financial system. This research makes clear by detailed examination of the negotiations that occurred among key policymakers that they looked to prior crises and issues rather than potential systemic risks from market innovations.

[808] National Commission, *The Financial Crisis Inquiry Report,* xix. This meant that for the investment banks, a “less that a 3% drop in asset values could wipe out a firm.”

[809] National Commission, *The Financial Crisis Inquiry Report* xxi.

The unique contribution of this dissertation is to demonstrate that the issue was not deregulation per se, as is commonly thought. In fact, the structure of GLBA preserved the underlying regulatory rules in each financial services industry. Rather, the error lay in treating financial services modernization as the repeal of the Depression-era financial regulatory framework instead of an opportunity to reform regulation of the financial system! [810]

In summary, there is little support for the contention that GLBA itself was a significant factor in causing the 2008 financial crisis. GLBA was an important law and represented the end of an era in regulation, but it was fundamentally a necessary codification of prior evolutionary changes enacted by regulators and approved by the courts. It had no meaningful impact on the housing crisis, regulatory failures, securitization trends, or the reduced capital standards that were contributing causes to the crisis. However, if one considers GLBA paired with CFMA, it is clear that in response to several long-term trends the 106th Congress missed an opportunity to strengthen the governance oversight of the OTC derivatives markets.

This omission was all the more tragic because after the LCTM crisis policymakers had discerned the necessary steps, such as netting, closing, and clearing transactions, to keep the OTC derivatives market from failing in a crisis. Unfortunately, both Congress and the regulatory community accepted industry arguments to keep these market

[810] Ben Bernanke, *The Courage to Act: A Memoir of a Crisis and Its Aftermath* (New York, NY: W.W. Norton & Company, 2015); Ben Bernanke, *The Federal Reserve and the Financial Crisis: Lectures* (Princeton, NJ: Princeton Univ. Press, 2013); Timothy F. Geithner, *Stress Test: Reflections on Financial Crises* (New York: Crown Publishers, 2014); Henry M. Paulson, *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System* (New York: Business Plus, 2010) are some of the better known of this genre.

regulatory measures voluntary rather than mandatory because of the prevailing neoliberal ideological consensus, a misunderstanding of systemic risks presented by derivatives, and interest in the global competitive position of the U.S. financial services industries. As a result, Congress missed an opportunity to mitigate the 2008 financial crisis.

Appendices

Appendix 1: Legislative, Regulatory, and Judicial Milestones[811]

1933 Glass-Steagall Act (PL 73-66)
Passed to prohibit commercial banks from investment banks, including the underwriting or selling securities

Legislation introduced every year from 1938-1956 to regulate Bank Holding companies in order to prevent monopolies

1956 Bank Holding Company Act (PL 84-511)
Defined a BHC as one owning 25% or more of at least two banks. Such BHCs were limited to banking and were prohibited from controlling assets in nonbanking activities. Included an exception for single-bank holding companies, which could engage in non-banking activities.

1966 House passed legislation to repeal the exceptions to the BHCA, but final bill signed into law by President Johnson incorporated Senate provisions to restore the single-bank holding company exception.

1970 Amendments to the BHCA of 1970 (PL 91-607)
Essentially applied the rules for BHCs to single-bank holding companies.

1971 Comptroller issues 12 C.F.R. § 7.7100 to clarify that the 1916 modification to the Federal Reserve Act, 12 USC § 92, which was also passed at the request of the Comptroller, "is applicable to any branch of a national bank which is located in a town with less than 5,000 inhabitants, even though the principal office of the national bank may be in a town with a population greater than 5,000 persons." Upheld in *Owensboro* (district court) and later by Supreme Court in *Barnett*.

1978 House failed to pass provisions to limited insurance activities by BHC

1980 House passed a bill to restrict BHCs from acting insurance agents but Senate failed to act 1980

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[811] Lantie Ferguson, "Decades of Efforts to Change the Glass-Steagall Act," *CQ Weekly*, October 23, 1999, 2505; "Evolution of a Law," ABA Banking Journal 91, No. 12, December 1999: 6-8. For summary of legislative milestones in the 106th Congress see Staff, "Legislative Summary: Banking and Finance - Financial Services," *CQ Weekly*, November 27, 1999, 2859–60; "Chart: Bills to Watch, 106th Congress -- First Session (as of April 2, 1999)," *CQ Weekly*, April 3, 1999, 813; "Chart: Bills to Watch 106th Congress -- First Session (as of June 18, 1999)," *CQ Weekly*, June 19, 1999, 1498; "Status of Major Legislation: 106th Congress -- First Session (as of May 28, 1999)," *CQ Weekly*, July 3, 1999, 771; Hendrickson, "Glass-Steagall Reform," 874; and Spong, *Banking Regulation,* 29-33.

The Depository Institutions Deregulation and Monetary Control Act of 1980 phased out interest rate ceilings on time and savings deposits, and equalized reserve requirements across all insured depository institutions while expanding Automatic Transfer Services, Negotiable Orders of Withdrawal, and share draft accounts nationwide. Also made Federal Reserve services, including credit facilities, available to all depository institutions offering transaction accounts.

1982 *The Garn Saint Germain Depository Institutions Act of 1982* increased the ability of regulators to aid distressed financial institutions, accelerated the elimination of interest rate ceilings, and further expanded the lending and investment powers of federal thrift institutions

Fed regulations authorize "toehold" investments by banking companies in banks across state lines. "Regional compacts" appear.

1983 President Reagan proposed to repeal Glass-Steagall but the Congress failed to act. There was general public agreement that repeal of Glass-Steagall would be harmful to consumer interests.

ICI v. Conover: ruling that commingled funds for IRAs are not mutual funds and therefore don't violate Glass-Steagall Act.

1984 Banking/Financial reform legislation introduced in both Houses but not passed

Citicorp files for Fed permission to establish a holding company subsidiary to underwrite and deal in bank-eligible securities. In 1987 this and other applications result in first approvals of "Section 20" subsidiaries.

SIA v. Board of Governors: Supreme Court approves of Bankers Trust placing commercial paper. Also, BankAmerica Corp.'s ability to own a discount brokerage subsidiary is successfully tested.

1985 *Northeast Bancorp.* Supreme Court upholds regional interstate compacts. Maine throws its doors open to nationwide comers.

1986 The Office of the Comptroller of the Currency declares national banks eligible to sell insurance nationwide.

Official end of deposit-interest-rate controls.

1987 Competitive Equality Banking Act (PL 100-86) closes nonbank bank loophole, but most players are grandfathered. also sets one-year moratorium, ending March 1, 1988, on bank powers expansions by federal regulators.

Supreme Court okays discount brokerage subs for national banks. In the same year, courts rule that nonmember banks can affiliate with securities dealers; say SEC has no jurisdiction over banks' securities activities; support acquisition of investment advisor and a discount brokerage firm by the same BHC; and expedite use of Regulation Y for insurance powers.

The Federal Reserve Board authorizes subsidiaries of bank holding companies to earn up to 5 percent of their revenue from underwriting and distributing commercial paper, municipal revenue bonds, mortgage-backed securities

1988 Banking/Financial reform legislation introduced in both Houses but not passed

1989 The Federal Reserve Board authorizes subsidiaries to earn up to 10 percent of their revenue from underwriting and distributing certain securities.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 provided $50 Billion to resolve failing thrifts, created a new regulatory structure for thrifts with significant FDIC involvement, increased deposit insurance premiums, and allowed bank holding companies to acquire any type of savings institution.

Creates Office of Thrift Supervision (OTS) under Treasury. Also kills FSLIC and creates SAIF.

Citicorp acquisition of municipal bond insurer is upheld as an incidental power of a national bank.

1991 The Federal Reserve Board authorizes foreign banks to underwrite securities through a subsidiary instead of through the subsidiary of a holding company.

Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) Implemented the international Basel I accord in the U.S. and required different amounts of capital depending on perceived credit risk of both on and off balance sheet assets. Included a "prompt corrective action" provision that subjects banks to sanctions if capital asset rations fall below certain thresholds.

Attempts were made to add banking and financial reform terms to this legislation, but the House and Senate could not reach a consensus

1992 *Owensboro* by U.S. district court decision finds that Sect. 92 of National Bank Act preempts state insurance law. However, Louisiana Supreme Court disagrees in *First Advantage Ins., Inc.* v. *Green,* 652 So. 2d 562 (La. Ct. App.), certiorari denied 654 So. 2d 331 (1995). Eventually resolved by Barnett.

Office of Thrift Supervision decides thrift branch are geographically unrestricted

1993 A Circuit Court judge rules that national banks can sell insurance in towns with 5,000 or fewer residents.

1994 *The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal)* created a consistent nationwide standard for interstate expansion, while allowing banking organizations to select the most efficient means for conducting their interstate operations

1995 Legislation was introduced to deregulate the financial services industry failed to reach the floor of the House

VALIC: The Supreme Court rules that variable annuities are a banking product that may be sold by banks, not insurance.

1996 *Barnett*: Supreme Court says National Bank Act of 1864, as modified by Federal Reserve Act of 1916, federal authorization for national banks to sell insurance in small towns of 5,000 or less cannot be preempted by a state's law barring national banks from selling insurance, even if only a branch is present in the small town.

Comptroller's "First Union letter" further opens national bank insurance powers.

Comptroller's Office issues Part 5 "op-sub" rules. National banks may apply to start subsidiaries to go into business areas that banks themselves cannot. Zions, first applicant, wins ability to underwrite muni bonds.

The Federal Reserve Board authorizes subsidiaries to earn up to 25 percent of their revenue from underwriting and distributing certain securities.

1997 Banking and insurance communities' differences again prevented legislation.

1998 Banking and financial reform legislation passed the House by one vote. It failed in the Senate over community reinvestment act provisions and unresolved concerns about operating subsidiaries.

Citicorp and Travelers Group agree to merge into Citigroup. Federal Reserve approves merger with caveats if Glass-Steagall not repealed

1999 *The Financial Modernization Act of 1999, or Gramm-Leach-Bliley Act* (GLBA) repealed the sections of the Banking Act of 1933, or Glass-Steagall Act, and the Bank Holding Company Act of 1956 (as modified in 1970) in order to allow affiliations among commercial banks, security firms and investment banks, and insurance companies under a financial holding company structure.

Senate Banking Committee approved 4 March.

House Banking Committee approved 11 March.

House Commerce Subcommittee approved 27 May.

House Commerce Committee approved 10 June.

Senate passed S.900 (S Report 106-44), 54-44, on 6 May.

House passed H.R. 10 (H Report 106-74, Parts 1-3), 343-86, on 1 July.

Senate adopted conference report on S.900 (H Report 106-434), 90-8, on 4 Nov.

House cleared the bill, 362-57, on 4 Nov.

President signed S.900 on 12 Nov.

2000 *Commodity Futures Modernization Act of 2000* (CFMA) updates the Commodity Exchange Act and renews the charter for Commodity Fair Trade Commission. Explicitly excludes from CFTC jurisdiction and allows but does not require clearing houses to be established for OTC derivative markets.

Appendix 2: Key Judicial Decisions

1959 *SEC v. Variable Annuity Life Ins. Co. of America*, 359 US 65 - Supreme Court 1959. "VALIC" required annuities to be registered with the SEC.

1965 *Whitney Nat'l Bank v. Bank of New Orleans & Trust Co.*, 379 U.S. 411, 419, 85 S.Ct. 551, 556-57, 13 L.Ed.2d 386 (1965). The Board of Governors of the Federal Reserve System has exclusive jurisdiction to interpret and apply the BHCA.

1984 *Chevron, U.S.A. Inc. v. NRDC, Inc.*, 467 U.S. 837, 842-45, 104 S.Ct. 2778, 2781-83, 81 L.Ed.2d 694 (1984). "*Chevron*" required judicial deference to an agency's interpretation of its governing statute in the absence of clear Congressional intent.

Securities Industry Assn. v. Board of Governors, FRS, 468 US 137 - Supreme Court 1984. In "*SIA v. Board*" the Supreme Court approved the placing commercial paper by banks.

1985 *Northeast Bancorp, Inc. v. Board of Governors*, FRS, 472 US 159 - Supreme Court 1985. In "*Northeast Bancorp*" the Supreme Court upheld the Federal Reserve Board approval of regional bank compacts (RBC), or banks acquiring other banks out of state but within a region in which the relevant states had passed laws permitting such acquisitions.

1986 *Inv. Co. Institute v. Conover*, 790 F. 2d 925 - Court of Appeals, Dist. of Columbia Circuit 1986. "*ICI v. Conover*" agreed with the Comptroller that banks can hold IRAs because the comingled funds in IRAs are not mutual funds and hence are not in violation of the Glass-Steagall Act.

1987 *Clarke v. Securities Indus. Ass'n*, 479 U.S. 388, 107 S.Ct. 750, 759, 93 L.Ed.2d 757 (1987). In "*Clarke v. SIA*" the Supreme Court upheld the Comptroller's approval for a national bank to own a discount brokerage subsidiary. This reaffirmed that the principle of judicial deference to an agency's interpretation of its governing statute applied to the Comptroller's interpretation of the National Bank Act.

Independent Ins. Agents of Am. v. Bd. of Governors, 835 F. 2d 1452 - Court of Appeals, Dist. of Columbia Circuit 1987. The Court agreed with Board rulings that the SEC has no jurisdiction over bank security activities; permitted the same bank holding company to acquire both an investment advisor firm and a discount brokerage; and modifications to Regulation Y to allow a bank to extend insurance activities permitted in a small town to areas outside the town itself.

1988 *Securities Industry Assn. v. Board of Governors*, 486 U.S. 1059 - Supreme Court 1988. Denied Certiorari (thus retaining 2nd Circuit decision); *Securities Industry Assn. v. Board of Governors*, 839 F.2d. 47 – 2nd Circuit 1988. The Courts accepted the Board's interpretation that Section 20 allowed bank holding companies to establish subsidiaries that could underwrite and deal in municipal revenue bonds, mortgage-backed securities, and third-party commercial paper.

Nat. Ass'n of Cas. & Sur. Agents V. Bd. of Gov., 856 F. 2d 282 - Court of Appeals, Dist. of Columbia Circuit 1988. "*Sovran and Maryland National*" affirmed that a bank holding company, by acquiring another bank holding company that held permission to sell insurance grandfathered under the Garn-St. Germain Act, could continue to sell insurance.

American Ins. Ass'n v. Clarke, 865 F. 2d 278 - Court of Appeals, Dist. of Columbia Circuit 1988. The so-called "AMBAC" case ruled that the respective federal regulatory agencies for banking have the authority to authorize a bank or bank holding company to offer municipal bond insurance.

1996 *Barnett Bank of Marion Cty., NA v. Nelson*, 517 US 25 - Supreme Court 1996. The "*Barnett*" case holds that, under ordinary pre-emption principles, the federal statute pre-empts the state statute, thereby prohibiting application of the state statute to prevent a national bank from selling insurance in a small town. The court decided that the federal statute in question, the National Bank Act of 1916, "specifically relates to the business of insurance." This was notable for its application of the McCarran-Ferguson Act, 15 U. S. C. § 1012(b), which provides that a federal statute will not preempt a state statute enacted "for the purpose of regulating the business of insurance" unless the federal statute "specifically relates to the business of insurance."

1998 *National Credit Union Admin. v. First Nat. Bank & Trust Co*., 522 US 479 - Supreme Court 1998. In the "Common Bond" case, the Supreme Court held that the National Credit Union Administration (NCUA) interpretation of a common bond violated the unambiguous statutory language requiring a common bond for membership in a credit union.

1999 *Independent Community Bankers v. Bd. of Governors*, 195 F. 3d 28 - Court of Appeals, Dist. of Columbia Circuit 1999. "*ICBA v. Board*" affirmed the Board's approval of the Citibank-Travelers merger to form Citigroup.

Appendix 3: Major Banking Regulatory Authorities[812]

Comptroller of the Currency

1. Established by the National Currency Act 1863 as modified by National Banking Act of 1864
2. Primary supervisory agency for national banks to ensure banking laws and regulations are followed, and to ensure the safety and soundness of the bank
3. Housed in the Bureau of the Treasury Department
4. The Comptroller of the Currency is appointed by the president to a five-year term and serves as a director of the FDIC
5. Supervisory authorities:
    a. Charter national banks
    b. Review national bank branch and merger applications
    c. Examine and supervise all national banks
6. Enforcement powers: Authorized to issue fines as well as cease and desist orders; place banks into conservatorship; suspend charters; and remove/suspend bank officials

Federal Reserve System[813]

1. Established in 1913 by the Federal Reserve Act
2. Headed by a Board of Governors each of which is appointed by the president to 14-year terms; one governor designated as chairman with a four-year renewable term.
3. Federal Reserve System (in addition to DC Board of Governors)
    a. 12 Federal Reserve Banks and 25 branches throughout the country
    b. Each Federal Reserve bank has board of nine directors, with three of six representing member banks and three from the business community.
    c. The other three are appointed by the Board of Governors
4. Federal Reserve System supervisory duties
    a. Serves as the primary supervisor and regulator of bank holding companies (BHC) and financial holding companies (FHC)
        i. Either reviews or receives notification of formation or expansion
        ii. Supervises the overall banking organization (i.e., the BHC not the bank)
    b. Directly supervises state-chartered banks that become members
    c. Reviews membership applications from state banks and, with state authorities, merger and branching proposals from state member banks

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[812] Spong, *Banking Regulation,* 51-60; Macey, Miller, and Carnell, *Banking Law and Regulation*, 70-73.

[813] The Federal Reserve has other public responsibilities including the conduct of monetary policy through open market operations, adjustments in the discount rate, and reserve requirements as well as acting as a fiscal agent for the federal government (i.e., services like check collection, currency and coin distribution, and fund transfers).

5. Enforcement powers: Cease and Desist orders; remove bank and BHC officers; levy fines; revoke membership; and order the divestiture or termination of FHC activities

Federal Deposit Insurance Corporation (FDIC)[814]

1. Established by the Banking Act of 1933, or Glass-Steagall Act
2. An independent federal agency managed by five directors including the Comptroller of the Currency, the director of the Office of Thrift Supervision, and three others appointed by the President for six-year terms. One of the three appointed directors is designated as chairman by POTUS for five-year term
3. FDIC directly supervises and examines insured state chartered banks that are not members of the Federal Reserve System
4. FDIC's main function is to insure deposits at commercial banks and thrift institutions:
    a. FDIC responsible for protecting insured depositors, acting as receivers for failed banks, and administering the deposit insurance funds
    b. Banks must apply and be approved by FDIC to obtain deposit insurance
    c. The bank insurance fund is financed through assessments on insured banks
5. Authorized to make special examinations of any insured bank when necessary to determine the condition for insurance purposes
6. Enforcement powers: Terminate of deposit insurance; cease and desist orders; remove bank officials and other affiliated parties; levy fines at state nonmember banks; appoint itself as conservator or receiver of an insured depository institution when deemed necessary to reduce risk of insurance loss

Federal Financial Institutions Examination Council

1. Created by Financial Institutions Regulatory and Interest Rate Control Act of 1978
2. The Council is composed of the Comptroller of the Currency, one governor of the Federal Reserve System, the director of the Office of Thrift Supervision, and the chairs of the FDIC and of the National Credit Union Administration Board
3. Its primary responsibility is to "establish uniform principles and standards and report forms for the examination of financial institutions."
4. It is also tasked to make recommendations on matters of common concern to supervisors; conduct schools for examiners and training seminars on risk management; maintain uniformity among federal regulatory agencies in identifying problem institutions and in classifying loans that involve country risk, or are large credits shared at multiple banks; and periodically meet with a liaison committee of five representatives from state financial regulatory bodies.

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[814] The FDIC gained authority 1989 to insure thrifts through the Savings Association Insurance Fund (SAIF). It may undertake special examinations of insured thrifts for deposit insurance purposes, and can prevent thrifts from pursuing activities or actions that would pose a serious threat to the insurance fund.

5. The agencies represented on the council retain their independence in most ways, so while council provides some consistency among regulatory agencies its recommendations are not always adopted

Securities and Exchange Commission (SEC)

1. Established in 1934 to regulate practices in the securities industry and is run by five commissioners appointed by the president
2. Serves as the primary regulator for activities conducted in a securities subsidiary of a bank or BHC
3. Banks and banking organizations are subject to SEC regulations and oversight:
    a. Many larger BHC must follow SEC registration requirements when they issue public stock, have stock traded on major exchanges, or make tender offers
    b. SEC has become involved in areas such as accuracy of bank loan loss reserves and other financial disclosures; appropriateness of insider stock trading; and bank mutual fund and securitization activities
4. Note, banks can avoid registering as brokers and dealers, and so avoid direct SEC supervision, if they limit their operations to a list of activities exempted under Gramm Leach Bliley.
5. Depending on activity, bank may also be subjected to other authorities, including National Association of Securities Dealers (NASD), Commodity Futures Trading Commission (CFTC), and Municipal Securities Rulemaking Board

Office of Thrift Supervision (OTS)[815]

1. OTS is a bureau of the Treasury Department. It has a director appointed by the president for five-year term. The director serves on the FDIC board
2. Bank organizations are under the oversight of one of the thrift regulators when they acquire and operate thrift institutions
3. OTS is primarily responsible for chartering, supervising, and regulating federal thrifts, savings associations and federal savings banks
4. In addition, OTS shares with state agencies supervisory and regulatory authority over state-chartered savings association belonging to the Savings Association Insurance Fund (SAIF)

Other federal agencies:

1. The Department of Justice antitrust division is responsible for enforcing federal antitrust laws and can review the potential effects on competition of any bank merger or holding company consolidation or acquisition of banks
2. Federal Trade Commission (FTC) investigates deceitful or misleading business practices. Shares with other agencies enforcement of the Truth in Lending Act and other consumer protection laws.
3.

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[815] State savings associations and state savings banks are chartered and examined by state thrift regulators, but authority is shared with either OTS or FDIC if thrifts obtain federal insurance.

State Banking Agencies

1. Every state has its own agency to charter and supervise banks. Banks chartered by the state must obey all applicable state laws and regulations
2. If state banks take out federal deposit insurance, or becomes a member of the Federal Reserve, it must comply with those federal regulations, even in cases where the state regulation is more lenient
3. The Conference of State Bank Supervisors (CSBS) provides a forum for discussing issues of common interest among all state bank regulators to assist states in maintaining efficient and effective banking departments
4. Typical supervisory authorities: Issue bank charters; conduct bank examination; construct and enforce bank regulations; and rule on proposed branch and merger applications
5. Enforcement powers: revoke state bank charters for unsound business practices; issue cease and desist orders; remove bank officials; and levy fines.

State Insurance Commissioners

1. Play key role in regulating the insurance activities of banks and bank affiliates
2. Each state has an insurance commissioner or insurance department as set out by the McCarran Ferguson Act, which grants the individual states and their insurance commissioners the general authority to regulate insurance activities.
3. Under GLBA, Congress created a framework for greater uniformity in state insurance agent and broker licensing laws. Three-year phase in period.

Appendix 4: Major Financial Trade Associations

Banking Trade Associations

1. American Bankers Association (ABA) – entire commercial banking industry
2. Independent Community Bankers of America - small banks. Note: competes with ABA for the support of small banks
3. Independent Bankers Association of America
4. America's Community Bankers
5. Financial Services Roundtable (formerly Banker's Roundtable) - forum for large expansion minded banks and other large nonbank institutions.
6. National Association of Federal Credit Unions represents Federal Credit Unions
7. Credit Union Association of America - represents the entire credit union industry

Investment and Securities Associations

1. Securities Industry Association (SIA) - wide range of investment banks, securities brokers/dealers, and investment companies
2. Financial Industry regulatory Authority (FINRA)
3. National Securities Dealers Association – predecessor to FINRA
4. The Investment Company Institute (ICI) - investment companies
5. International Swaps and Derivatives Association - participants in the privately negotiated swaps and derivatives business
6. American Financial Services Association - financial intermediaries that fund themselves in the capital markets

Insurance Industry

1. National Association of Insurance Commissioners
2. American Council of Life Insurers - life insurance companies
3. American Insurance Association - property/casualty companies
4. Independent Insurance Agents of America - agents not affiliated with any particular company
5. National Association of Life Underwriters – affiliated agents.

Government Associations

1. Congressional Liaison Offices - Treasury, federal banking agencies, and the SEC
2. State regulators
    a. Conference of State Supervisors
    b. American Council of State Savings Supervisors
    c. National Association of State Credit Union Supervisors
    d. North American Securities Administrators Association
    e. National Association of Insurance Commissioners

Appendix 5: Key Laws in the New Deal Banking Regulatory Structure[816]

National Banking Acts of 1863-1864

- Established national banking structure
- Undermined state bank currencies

Federal Reserve Act of 1913

- Established the Federal Reserve System
- Initially focused primarily on monetary policy

McFadden Act of 1927

- Allowed national banks to branch to the extent of each state's laws
- Specifically prohibited interstate branching by allowing national banks to branch only within the state in which it located.
- Eventually repealed by the Riegle-Neal Interstate Banking and Branching Efficiency Act

Federal Home Loan Bank Act of 1932

- Establishes the Federal Home Loan Bank Board (FHLBB), which charters and supervises federal S&Ls
- Establishes the Federal Home Loan Banks (FHLBs)
- Gives the FHLBB authority to regulate and supervise S&Ls
- Gives FHLBs the authority to lend to S&Ls to finance home mortgages

The Securities Act of 1933

- This act requires strong disclosure statements of publicly held corporations
- Intended to deprive investment bankers of their monopoly on information

The Banking Act of 1933

- Extends federal oversight to all commercial banks for the first time
- Separates commercial and investment banking (Glass-Steagall Act)
- Prohibits banks from paying interest on checking accounts
- Allows national banks to branch statewide, if allowed by state law
- Gives the FDIC authority to provide deposit insurance to banks
- Gives the FDIC the authority to regulate and supervise state nonmember banks
- Funds the FDIC with loans of $289 M through the U.S. Treasury and the FRB

The National Housing Act of 1934

- This act creates the Federal Savings and Loan Insurance Corporation (FSLIC), which is administered by the Federal Home Loan Bank Board (FHLBB).
- FSLIC insures S&L deposits until 1989, when the FDIC assumes responsibility for the bankrupt fund as the Savings Association Insurance Fund (SAIF)

The Securities Exchange Act of 1934

- Creates the Securities and Exchange Commission (SEC)

[816] https://www.fdic.gov/about/history/timeline/1930s.html

- Requires any company whose securities are traded on national exchanges or over-the-counter to file registration applications and annual reports with the SEC that detail the economic health of the company

The Banking Act of 1935
- Establishes the FDIC as a permanent agency of the government (FDIC Act)
- Provides for permanent deposit insurance and maintains it at the $5,000 level

The Commodity Exchange Act of 1936
- Replaced Grain Futures Act of 1922
- Provided federal regulation of commodity and futures trading and exchanges

McCarran Ferguson Act 1945
- Established primacy of state law over federal insurance law unless Congress legislates explicitly about insurance
- Interpreted by *Barnett v. Nelson* to give Comptroller authority over insurance in national banks under Section 92 of the National Banking Act (i.e., "less than 5000" rule)

The Federal Deposit Insurance Act of 1950 [817]
- Revises and consolidates earlier FDIC legislation into one act
- Increases the insurance limit from $5,000 to $10,000
- Gives the FDIC the authority to lend to any insured bank in danger of closing, if the operation of the bank is essential to the local community
- Authorizes the FDIC to examine national and state-member banks to determine their insurance risk

Bank Holding Company Act of 1956
- Overall, intended to prevent banks from end-running the Glass-Steagall Act by forming bank holding companies
- Prohibits the expansion of bank holding companies into "non-banking" activities through affiliates, including insurance and securities
- Includes a provision, known as the Douglas Amendment after its author, Senator Paul Douglas, D-IL, to prohibit bank holding companies headquartered in one state from acquiring a bank in another state unless that other state's laws specifically authorize such an acquisition.
- Assigned oversight authority for Bank Holding Companies to the Federal Reserve

The Bank Holding Company Amendments (BHCA) of 1970[818]
- Require Federal Reserve Board approval for the establishment of a single-bank holding company
- Applied the "closely related to banking" rule to acquisition of subsidiaries by single-bank holding companies

The Commodity Futures Trading Commission (CFTC) Act of 1974

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[817] https://www.fdic.gov/about/history/timeline/1950s.html
[818] https://www.fdic.gov/about/history/timeline/1970s.html

- Modified the Commodity Exchange Act to create the CFTC
- Futures Trading Act of 1978 ceded the authority of the Secretary of Agriculture to the Chairman, CFTC

Community Reinvestment Act (CRA) of 1977

- Directs banks and S&Ls to meet the credit needs of their communities, including low-income areas
- Requires the FDIC to examine non-member state banks for CRA compliance.

Appendix 6: 106th Congress Senate and House Committee Bills[819]

Issue	S.900	H.R. 10 (Commerce)	H.R. 10 (Banking)
Regulatory Structure	Requires banks use of holding company structure with Fed oversight, except banks <$1B assets may use operating subsidiaries regulated by OCC	Requires banks use of holding company structure, except insurance may be an operating subsidiary	Allows banks option of operating subsidiaries, except insurance underwriting/real estate development must be affiliated in a holding company
Thrifts	Prohibit new and existing thrifts from affiliating with commercial firms but existing affiliations may be retained	Same as S.900	Prohibit new thrifts from affiliating with commercial firms but existing thrifts allowed to affiliate
Privacy	N/A	"Opt-out" of information sharing allowed; restricts disclosure of medical information	Requires financial firms to disclose privacy policies to customers; restricts disclosure of medical information
CRA	Exempt rural banks <$100M from CRA. Includes "sunshine" provision to disclose financial agreements with activist groups	Same as House Banking	Maintains existing law but require satisfactory CRA ratings for new affiliations to be approved
Insurance Regulation	State regulation of insurance activities by national banks, but bank insurance activities must be g treated the same as other insurers	Similar to Senate	Similar to Senate
Securities Regulation	Limited SEC oversight of bank securities activities	SEC oversight of bank securities activities	Similar to Senate

819 "Chart: Financial Services Bills Compared," *CQ Weekly*, June 26, 1999, 1545.

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Carl Albert Congressional Research and Studies Center, University of Oklahoma
Citi Heritage Collection, Citigroup
James A. Leach Papers, University of Iowa
JT Ball Collection, University of Mississippi
Phil Gramm Papers, Texas A&M Cushing Memorial Library
William J. Clinton Presidential Library & Museum
Securities Exchange Commission Historical Society

Government Digital Records Consulted

Board of Governors of the Federal Reserve, FRASER
Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency, U.S. Department of the Treasury
U.S. Department of the Treasury
U.S. National Archives (Congressional Records embargoed for 20 years)
U.S. Commodity Futures Trading Commission
U.S. Securities and Exchange Commission

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