

Changes in Financial Institution Regulations Associated with the Repeal of the Glass- Steagall Act of 1933

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Abstract

The banking regulatory system plays a very important role in the economy as it offers various measures that assist in the running of the industry. The purpose of this literature review is to identify how depository institutions and investment banks were regulated by the Glass-Steagall Act (1933) and how its policies were amended via the Gramm-Leach-Bliley Act. These Acts further define the business practices that govern financial institutions. In addition, they illustrate further how the removal and change of some of their regulations has affected financial business operations and the economy. This is important as the major areas that need improvement can be identified thus creating room for policies that can be developed to enhance the stability of these institutions. Congress can use such measures as a way of salvaging the failing economy and restoring consumer confidence in financial institutions within the United States.

Introduction

Financial regulations are important in business as they enhance the stability of the country through the various monetary policies in place. These regulations are imperative as they require business to act accordingly in ensuring the safety of the financial assets and investments of businesses and individuals. The objectives of financial regulation therefore entail enhancing safety and soundness of the system through the enactment of proper policies and monitoring of depository institutions. This is important as it enhances consumer and investor protection. The current financial structures are complex either in terms of their formation, legal restrictions and understanding the policies that govern the country. It is therefore important that consumers and investors are protected against potential fraudulent schemes. This enhances fairness by proper allocation of resources and setting of laws against indiscriminate lending practices that has contributed to the collapse of some organizations.

Literature Review

Several regulations have been used to govern the way investment banks and depository institutions work in the United States of America. For example, the Bank Holding Company Act of 1956, the Depository Institutions Deregulation and Monetary Control Act of 1980, and the International Banking Act of 1978. These Acts regulated the lending capabilities of financial institutions, and their ability to purchase failed commercial banks and distribute insurance.

One of the major banking legislations enacted was the Glass-Steagall Act (Banking Act) of 1933. This Act was used to disallow commercial banks from underwriting securities apart from state bonds which included municipal and government bonds as well as loans made on real estate. In addition, the Glass Steagall Act (GSA) was used to form the Federal Deposit Insurance Corporation and banking policy improvements that would aid in monitoring the controls of the country's financial institutions (Greene, 2005).

The Glass-Steagall Act was written by U.S. Senator Carter Glass and U.S. Representative Henry Steagall, and was the first Act that was passed in 1933 with the aim of controlling deflation and giving the Federal Reserve Board the ability to lower their interest rates so banks were in a position to offer government bonds to the public

(Cohen, 1985). The GSA was formed at a time when the U.S economy was under one of its worst depressions at that time. Congressional hearings revealed conflicts of interest and fraud in some banking institutions securities activities (Jackson, 1987). The banking system had failed; characterized by many banks closing, which led to spiraling unemployment and an erosion of consumer confidence in the system itself. A revolution needed to be made in order to restructure the banking system and the Glass-Steagall Act (1933) made this possible. “The GSA was put in place so that it could help in the restructuring of the economy when most of the commercial banks in the country were collapsing (Rosenthal et al, 1988).” This can be likened to some of the financial problems that are being experienced in the country today. Most of the problems then were attributed to the collapse of the stock market such that foreign investment was also reduced. The GSA enhanced the Federal Reserve System to accept currency other than gold backed currency thus creating a new system of financial governance in the country that is also being used today.

Why the Glass-Steagall Act Was Necessary

It separated commercial banking and investment except in areas with regard to treasury securities, general municipal bonds, and private debt and equity securities. Investment banking was and is still considered risky and that is why this regulation was necessary. Sections 16 and 21 of the GSA addressed the roles of commercial banks such that they were also restricted from participating in the issue or purchasing of stocks with exceptions made in the government bonds (Czyrnik, 2001). It was necessary to separate commercial and investment banking because the separation minimized the risks of losses that organizations had to deal with. This was because the banks that engaged themselves in underwriting had incurred huge losses and the government had to support them financially, thus using money that was supposed to be channeled to other necessary sectors of the economy such as education and health. If this would have continued over a long period, the government would have to limit the funds that are loaned out and this would have meant that the public would have lost further trust in the banking system.

The separation of commercial and investment banks was necessary because it was observed that when banks decided to participate in other business ventures, they would always want to please both parties and in some cases this was impossible, thus resulting in conflicts which were never resolved on time. The people who were mainly affected by such acts were the customers. According to Khambata “This separation was necessary so that improper banking activities could be minimized (1996).” Even if banks tried to adhere to the law so as to keep the various abuses minimal, the way investments are run cannot be compared to the banking system and linking the two was seen as complicating the system.

Separating investment and commercial banking made sense because it meant that the government was only going to support the banks that were protected under the FDIC, and not taken advantage of by other financial institutions whose debts are as a result of other activities that the government is not entitled to support. “In addition, the division between investment and banking would lessen the powers that would have emerged when the underwriting firms intensify their competition and supersede commercial banks through unfair competitive practices (Jackson, 1987).” If banking and investment were not separated, this would mean that the banking system would not be specialized and this means that the in the long run customers and the economy would be affected. This may be attributed to the cause of the current banking system failure as the GSA was repealed in 1999 and depository institutions and investment banks were no longer separated.

Bank expansion operations were limited as such that they were regulated from investing in other financial companies, and this was enacted into law in 1980 under the Depository Institutions Deregulation and Monetary Control Act. The Gramm-Leach-Bliley Act in 1999 enabled banks to acquire other banks. Initially, the financial system performed all the banking functions and this included investments. The GSA was important as it separated the two and this was good for business, as it enabled the banks and investment banks to be run efficiently but separate of one another, allowing for a stronger US banking system. Another reason why the GSA was important is because the depository institutions had a lot of authority as they control their client’s funds. This power needed to be minimized so as to enable competition in the financial market. Investment in stocks was and still is risky, and this could affect the security of the institutions deposits. The repeal of the GSA and the passage of Gramm-Leach-Bliley essentially removed these limits and protections from the industry.

The federal government, which is in control of money in the economy, will therefore be left to compensate investors for the losses that may result when the depository institutions fail. Moreover, depository institutions are able to control the risks that may affect the financial well-being of their institutions. This means that competent managers are needed to undertake such tasks and the GSA allowed them to do so, thus enhancing the stability of the financial market and the economy in general. This in turn attracted more investments that provided enough capital for the institutions to operate effectively.

The Repeal of the Glass-Steagall Act

One reason cited for the repeal of the GSA was it forced the depository institutions to operate in properly regulated financial systems. This is because the Glass-Steagall Act did not clearly demarcate between loans, investment stocks and deposits in its law and how they were to be defined (Czyrnik, 2001). This meant that people were losing their investments, especially in the firms that were not well controlled as well as foreign institutions whose provisions were not included in the law. Moreover, there were conflicts in the way credit was offered to customers and businesses and how this credit was used in investment.

The investment banks did not lay down policies with regards to the usage of credit, and investment banks sometimes acted in their own interest without thinking how they were affecting their clients. Another reason was that securities in the depository institutions were very risky and this would mean that the organizations that dealt in them risked to be affected negatively as a result of any economic changes (Laird, 1998). Furthermore, since the depository system always worked in unison with the banking and the security markets, the GLBA would enable the financial institutions to learn from the various loopholes in the GSA and this would make them keener in avoiding the underlying causes of collapse of the country's financial system. The GSA was also not seen as a major governing tool; therefore it could be easily eliminated without affecting the financial institutions thus encouraging competition in the industry (Laird, 1998).

Why Change was Needed in the Banking Sector

Legislators have always tried to promote the growth of the banking industry by enacting certain laws that enhanced the expansion of the business. In the 1930s and 1940s, banks dealt mainly with deposits and issuing loans, and needed more leeway to enter other financial markets to enhance the growth of the banking industry. The Bank Holding Company Act of 1956 tried to reduce these opportunities by creating regulations in banking and insurance so as to create a wall between the two, and limit the expansion activities of banking institutions. Congress also saw that the banks were taking risks that would result in huge losses not only for themselves but also the economy (Markham, 2002). Moreover, big financial companies at that time were seen as the cause of the financial problems of the 1930's and that is why some of their services were minimized as a way of preventing the banks from using their clients' deposits when they had limited funds (Heakal, 2009).

The banking sector wanted the GSA to be abolished as it restricted the activities of saving and investment banks. These issues were presented to the House of Representatives by Senator Phil Gramm of Texas. The House then reviewed what was to become the Financial Services Act of 1999. When the vote was passed for the first time, the Democrats and Republicans of the House could not agree on the bill as a new law that protected clients financial privacy was needed. The House and the Senate presented their versions and the Democrats agreed to back the bill on condition that the Republicans would allow the Community Reinvestment Act (CRA) to be restructured to ease mortgage restrictions and ensure that the privacy issues were addressed. After the agreement, the bill came to pass as voted by the majority in both the Senate and the House and became law when signed by the then President Bill Clinton in 1999. The dissolution of the Glass-Steagall Act saw banks such as Citigroup engage in the trading of mortgages in the security market as well as establishing various investment structures (Mollenkamp, Brooks, 2001).

Gramm-Leach-Bliley Act of 1999 (GLBA)

This Act came into being as a repeal of the Glass-Steagall Act, thus allowing banks and insurance institutions to merge operations. It also gave the states the authority to control insurance policies such that banks are

allowed sell insurance just as the insurance companies themselves. In addition, investment banks were allowed to undertake commercial banking, and to invest and deal in real estate and other activities that are found within the law.

According to the Gramm-Leach-Bliley Act (GLBA), municipal bonds are now able to be traded under this law, and financial institutions are prevented from revealing their clients information to the public. Individuals who break the privacy law stand to be fined and subject to criminal prosecution for doing so (DeLong & Ramirez, 1996). This is good for businesses that are protected by the law, but it is bad for the general public who are not aware of the progress of certain businesses and if they have invested in the companies, they risk losing a lot of money. This can be said to have contributed to the current financial crisis that is facing the country and has slowly trickled to the rest of the world. People were unaware that certain big companies were not doing very well until it was too late in the day when nothing could be done to protect their investments.

Several changes were made in the Community Reinvestment Act which restricted financial companies from being formed if they did not attain the required CRA standards as well as insure their depository institutions against risk (Cocheo, 1999). Grants would be given to upcoming financial institutions if they showed progress in their ratings of providing mortgage opportunities to those previously denied access. The GLBA enhanced activities between the commercial companies and the depository institutions. In addition, the act eased some procedures for acquiring loans that were used by the Federal Home Loan Bank system (Blount, 2008). This therefore meant that more people can access loans which are used in productive ventures in the economy, thus assisting in its growth.

How the Gramm-Leach-Bliley Act of 1999 has Changed financial Firms' Business Conduct

The GLBA was a relief to the banks as well as the insurance companies as it addressed some of the changes that they wanted. Before GLBA was enacted, it was illegal for the investments companies and banks to merge in accordance to the GSA. Under the GLBA, it was possible that companies such as Travelers and Citigroup could merge.

The GLBA ensured that there were rules which were meant to be followed by everyone. This was because some banks and investment organizations used to evade following some rules in the GSA because banks were restricted from selling securities, but some banks did so under the guise of a separate institution (Santomero, 2001). The GLBA was to ensure that the financial business code of ethics took center stage and those who broke the law risked being penalized. It is this fear of incurring extra legal expenses and destroying the companies image that has made the financial institutions more organized and coordinated so that they can provide better and improved services to their clients (Heakal, 2009).

Improved business practices enhanced by the law allowed smaller financial institutions to increase their assets because they were supported by other organizations. Some retail banks also engaged in insurance brokerage as a means of increasing their profits. The GLBA provided the banking industry a lot of business opportunities to develop themselves as well as provide employment for the masses. The Act enhanced the growth of the industry by incorporating strategic business development plans into their operations. This was a positive influence for the banks as they knew in order to be successful, they have to invest in proper business plans which entail forecasting and analyzing business trends that are directed by results-driven leaders (Gordon, 1999). Banks were therefore required to analyze the types of businesses they engage themselves in so that they can avoid presumptive business ideas that can lead to their demise, as experienced recently by some institutions.

To ensure that businesses are protected in the financial market, the GLBA was written in such a way that it does not allow the mergers of organizations that do not meet CRA (Community Reinvestment Act) standards. The GLBA also insisted on the rule that the financial institutions are not allowed to own non-financial organizations (Birritteri, 2001). Likewise, other non-bank institutions are not allowed to join the commercial banking industries. This ensures that there is continuity in all forms of business in the country, providing stability within the industry.

These restrictions are important as they govern the investment and banking practices of an organization so that roles are defined and that the various segments concentrate in offering the best services to their clients. The GLBA also included the Financial Privacy Rule, which addresses the issue of disclosure about their client's information.

The Financial Privacy Rule

Financial institutions are supposed to give their clients notices which outline any information collected about the client and how it will be used. An agreement is signed between the client and the financial company such that the company will be held liable for any damages thereafter. The GLBA also safeguards customers from pretexting practices which occur when people will try to get non-public information without being given permission (Santomero, 2001). This action is punishable by law if a person is found to have engaged in it. The GLBA encourages the financial organizations to use the safeguard rules as they develop plans for implementation. Educating and training employees about the programs is also useful as they will develop methods of dealing with privacy issues.

The GLBA defines financial institutions as well as their roles. It also defines the consumers and the rights they have. This is important as it helps people and institutions to understand the roles they play in the financial industry, and the ethics that govern their operations and relationship. Through the GLBA, banking institutions have developed foreign expansion where they undertake underwriting, distribution, and brokering securities in foreign countries, such as England. But it was not possible for other foreign banks to do business in the U.S. as they were restricted from doing so by the International Banking Act of 1978 (Santomero, 2001). The GLBA removed these limitations, allowing banking institutions to expand their businesses in the global market.

Conclusion

In response to the failed policies of the U.S. banking system during the great depression, congress enacted the Glass-Steagall Act of 1933 to regulate the perceived cause of these bank failures. The GSA created a regulatory “wall” between commercial and investment banking, to prevent a loss of bank deposits in case investments were negatively affected as a result of a financial crisis. The intent of the GSA was to protect the deposits of bank customers from the risks (stock market collapse, recession) associated with investment banking.

The GSA was repealed in 1999 with the passage of the Gramm-Leach-Bliley Act (GLBA). Essentially, this act broke down the regulatory “wall” of the GSA and allowed financial institutions to enter new markets (insurance, mortgages, and securities) in response to an ever-expanding global financial marketplace. The GLBA also allowed foreign financial institutions to enter the U.S. market for the first time.

Has the repeal of the GSA, along with the passage of GLBA, created any financial problems in the U.S. and global finance market? One only needs to examine our current economy. Commercial and investment banking firms utilized the new freedom given them from GSA regulations so adroitly that in less than 10 years time, it became necessary for the U.S. Treasury to “lend” them 700 billion dollars to avoid failure of the entire U.S. banking system.

Government regulations of an industry become necessary when the industry, through either greed, neglect or indifference, refuses to do what is in the best interest of its customers and society in general. The lessons of the U.S. depression required the government to regulate and separate commercial and investment banking for the good of society, and to protect financial institutions from their own greed, through the GSA. The GSA’s repeal in 1999 and the resulting financial problems in the U.S. from the abuses provided by the GLBA show we have neither learned from our past mistakes, nor have a regulatory answer for fixing our financial institutions today.

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