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DEREGULATION AND THE 2008 FINANCIAL CRISIS IN AMERICA

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Abstract

This paper strives to understand the role of the deregulation movement in the 2008 financial crisis, which almost destroyed the US economy. Financial regulations created a legal barrier that safeguarded the US economy for four decades after the Great Depression. With the intent of improving the competitiveness of the US financial industry in the global economy, the US government adopted many deregulatory measures from the 1980s to the 2000s. For a short while, financial deregulation stimulated impressive economic growth. However, this temporary prosperity was subsequently overshadowed by the greatest financial disaster in modern history. This paper shows how the financial regulatory edifice was initially established after the Great Depression and how it was gradually eroded by the deregulation movement, which ultimately contributed to the 2008 financial crisis. Also, the remedies and new regulations that were introduced during and after the crisis are discussed.

Keywords

Deregulation, Financial Crisis, US Economy

1. Introduction

After the Great Depression, the US government introduced a series of financial regulations and created several government agencies to safeguard the financial industry. For almost four decades, no major crises occurred. As the US economy underwent stagflation in the 1970s, many academic economists lost faith in the Keynesian model of government intervention in the economy. The deregulation movement, championed by the laissez-faire Chicago school of economics, began to increase in popularity. With the intent of improving the competitiveness of American banks in the global economy, the US government started deregulating the financial industry. In 2008, a financial crisis imploded Wall Street. The subsequent economic collapse cost “millions of people in America...their homes and jobs” (Stiglitz, 2010, p. xi).

1.1 The New Deal: Enactment of Financial Regulations

The 1929 stock market crash precipitated a cataclysmic economic depression (Benston, 1990, p. 1). The blame was placed upon the consolidation of commercial and investment banking interests, especially after the Pecora Hearings held between 1932 and 1934. In those hearings, Ferdinand Pecora, chief counsel of the Glass Subcommittee of Congress, uncovered various abuses involving large banks and their securities affiliates, most notably National City Bank and Chase National Bank (Benston, 1990, p. 2).

The first defendant, National City Bank (NCB), was accused of selling bonds while giving investors “inadequate or misleading information”, “steering depositors to the securities affiliate” National City Company (NCC), and using the “affiliate to disguise bad banking practices and to hide losses from the stockholders” (Benston, 1990, p. 48). All three charges were used as evidence by Pecora that banks with securities affiliates were capable of horrid abuses and that the banking system needed a barrier separating commercial and investment banking. Similarly, Chase National Bank (CNB) was accused of “excessive trading in the bank’s stock for personal [profit]” and using “affiliate corporations to do indirectly that which the bank could not legally do directly.” Those were both activities conducted primarily with the help of affiliates (Benston, 1990, p. 77).

Following these damning revelations, the consensus shifted strongly in favor of separating commercial and investment banking. Senator Carter Glass proposed a regulatory barrier between the two sectors. In 1933, his legislation, the Banking Act (Glass-Steagall) (U.S.

Congress House, 1933b), was passed by Congress and signed into law by President Franklin Roosevelt (Benston, 1990, p. 1; Light, 2016).

In addition to separating commercial and investment banking, Congress also passed the Securities Act of 1933 (U.S. Congress House, 1933a). This law empowered the federal government to oversee the securities trade and required securities traders to provide potential investors with accurate and comprehensive information about the relevant securities (Kenton, 2019b).

To ensure the full enforcement of the 1933 Securities Act, Congress also passed the Securities Exchange Act of 1934 (U.S. Congress House, 1934), which established the Securities and Exchange Commission (SEC) to “oversee securities...as well as markets and the conduct of financial professionals” and to compel “all companies listed on stock exchanges” to comply with its rules (Kenton, 2019a).

After these vigorous efforts, a primitive barrier was established in America to safeguard the financial industry and prevent the mistakes of 1929 from being repeated.

2. The Deregulation Movement: Fall of the Regulatory Wall

The US did not have a single financial crisis for four decades after the Great Depression (Ferguson, 2010), during which the financial industry was tightly regulated. Despite this impressive record, from the 1980s to the 2000s, a deregulation movement slowly grew with Congress repealing many Depression-era regulations (Ferguson, 2010).

2.1 Doubt: Revolt of Academic Economists

1970s-era stagflation made many economists lose faith in the Keynesian model of government intervention in the economy (Backhouse, 2002, pp. 236, 294–297). This led to an increasing hostility towards regulation spearheaded by the Chicago school of economics. Proponents of laissez-faire economics argued that in the wake of globalization, antiquated financial regulations prevented US banks from competing with less regulated foreign banks (Federal Reserve Bank of San Francisco, 2002). For example, they were especially concerned that only American and Japanese banks were required to follow Glass-Steagall type laws that hindered diversification (Benston, 1990, p. 2). Later on, laissez-faire economists attributed the impressive economic growth of the 1980s and 1990s to financial deregulation enacted by the Reagan and Clinton administrations (Hershey Jr., 1984). One of the most common arguments of

deregulation advocates was that government-mandated financial regulation went against free-market principles (Richman, 2012).

Although laissez-faire economics was hardly a new idea, it had been previously marginalized in favor of Keynesian economics (Backhouse, 2002, pp. 236, 294–297). The renewed popularity of free-market theories was not just a result of 1970s stagflation but also the outcome of increased corporate influence over both the Democratic and Republican Party (Ferguson, 2010).

2.2 Initial Cracks: The Reagan Era

In 1980, when Ronald Reagan was elected president, he escalated the deregulation of the financial industry to an unprecedented degree. Before the Reagan era, investment banks were small private partnerships in which the partners contributed their own money and thus always attempted to avoid taking aggressive risks (Ferguson, 2010). But when those very banks went public, huge amounts of shareholder funds began flooding in, and the banks increased in size dramatically (Ferguson, 2010). In 1982, Congress passed the Garn-St. Germain Act (U.S. Congress House, 1982), which allowed banks to issue adjustable-rate mortgages and drastically changed the mortgage industry (Krugman, 2009b). Although adjustable-rate mortgages helped many Americans buy their own homes, during the 2000s housing bubble, they were exploited by subprime mortgage lenders, who left borrowers at the mercy of the volatile market after initially low-interest rates expired.

2.3 Corrosion: Alan Greenspan and the Federal Reserve

In 1987, President Reagan appointed Alan Greenspan, a staunch opponent of regulation, as the Chairman of the Federal Reserve (Ferguson, 2010). Greenspan helped thwart attempts by the Federal Reserve to regulate the financial industry. Notably, he delegated regulatory responsibility to the Federal Reserve Bank of New York, which had a board of directors made up of bankers inimical to government regulation (Morgenson & Rosner, 2012, p. 44). Later, despite being given the power to do so by the Home Ownership and Equity Protection Act of 1994 (U.S. Congress House, 1993), Greenspan did not regulate the mortgage industry during the 2000s housing bubble or mitigate its risks by mandating higher down payments on homes (Ferguson, 2010). He also refused to require higher margin requirements for stock trading or to reign in the derivatives market (Stiglitz, 2010, p. 8). Ultimately, these actions played a key role in causing the 2008 financial crisis.

2.4 Implosion: Clinton Era Deregulation

The election of Bill Clinton only strengthened the tide of deregulation. President Clinton believed that in the “modern” economy, the best way for American finance to remain globally competitive was to eliminate barriers that might “choke” a bank’s efficiency, such as Depression-era financial regulations (Time Editorial Board, 2009). To advance this policy agenda, he appointed Robert Rubin and Larry Summers—both staunch deregulators—as his first and second secretaries of the Treasury (Ferguson, 2010). Among many deregulatory laws that Clinton signed was the Riegle-Neal Act of 1994 (U.S. Congress House, 1994), which repealed the McFadden Act of 1927 (U.S. Congress House, 1927), a law that banned interstate banking (Liberto, 2019).

In 1998, the commercial bank, Citicorp, and the insurance firm, Travelers Group, merged to form Citigroup, an action that was illegal under the Glass-Steagall Act. Alan Greenspan, a vocal opponent of the Depression-era banking law, granted the merger a one-year exemption, during which Deputy Treasurer Summers and Treasurer Rubin successfully urged passage of the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (GLBA) (Ferguson, 2010). This law overturned Sections 20 and 32 of the Glass-Steagall Act, which prevented mergers among investment, insurance, and commercial banks (U.S. Congress Senate, 1999). One of GLBA’s staunchest opponents, Senator Byron Dorgan, complained that the law would allow banks to become “too big to fail” (Dorgan, 1999). However, over his objections, the bill was passed by Congress and signed into law by President Clinton. Under the Riegle-Neal Act, banks could now expand by opening branches across state lines, and GLBA allowed investment, commercial, and insurance banks to consolidate into a single entity. Consequently, the assets under management of the six largest banks grew from 20 percent of GDP in 1997 to 60 percent of GDP in 2008 (Lin, 2017). When these banks became “too big to fail,” they started making risky decisions. They knew that if they ever failed, the government would have no choice but to bail them out; otherwise, their collapse would enormously impact the economy (Dorgan, 2009, pp. 35–41). But in the 2008 financial crisis, when the Federal Reserve refused to bail out Lehman Brothers, Lehman was pushed into bankruptcy, and a collapse of the financial sector subsequently occurred. As a result, the entire economy came crashing down as well.

2.5 Coup de Grace: War on Derivatives Regulation

In May 1998, concerns over the risk posed by new financial instruments called over-the-counter derivatives prompted Brooksley Born, the director of the Commodity Futures Trading Commission, to issue a proposal for regulating derivatives. However, the Treasury, Federal Reserve, and SEC all rejected Born's proposal (Ferguson, 2010), and in December 2000, at the urging of Senator Phil Gramm, Congress passed the Commodity Futures Modernization Act (U.S. Congress House, 2000), which banned further regulation of the derivatives industry (Ferguson, 2010).

During that period, banks invented two kinds of derivatives: collateralized debt obligations (CDO) and credit default swaps (CDS). Under a process called securitization, mortgage lenders sold their mortgages to investment banks, who then combined them into tradable securities called CDOs and sold their shares to investors. This process transformed mortgages from strictly regulated long-term commitments between lenders and borrowers to shares owned by many investors (Ferguson, 2010). A CDS is an insurance policy against the possible default of a CDO. Like other derivatives, CDOs and CDSs were complicated and sometimes extremely risky (Ferguson, 2010). Furthermore, investment banks created many additional derivatives around the same CDOs, which greatly amplified the impact in case the underlying CDOs failed. Ultimately, this precarious, unregulated market caused many investment banks and insurance companies to collapse in 2008.

2.6 Mopping Up: Repeal of the Net Capital Rule in 2004

The Net Capital Rule was implemented by the SEC in 1975 to help banks manage investment losses by mandating a capital cushion. But this requirement also sharply reduced banking profits. Thus, Henry Paulson, the CEO of Goldman Sachs, lobbied the SEC to relax the rule and allow banks to greatly increase their leverage ratio. On April 28, 2004, the SEC repealed the Net Capital Rule and lifted leverage limits on investment banks. Subsequently, the leverage ratio for some banks rose to 33 to 1, which meant that a "tiny, 3 percent decrease" in asset base value would implode the bank's financial position (Ferguson, 2010). This precarious leverage ratio was one of the major reasons why so many banks, including Bear Stearns and Lehman Brothers, encountered trouble in 2008 (Sorkin, 2009, p. 81).

2.7 Miscellaneous Negligence by Regulators

Besides the dismantling of regulative barriers, the reluctant enforcement of regulations also contributed to the 2008 financial crisis. During the housing bubble, the SEC did not initiate any investigations into investment banks, even when it became clear that the banks were trading in “junk securities” (Ferguson, 2010). Additionally, many renowned credit-rating agencies, such as Standard & Poor’s, Fitch, and Moody’s, gave AAA ratings to risky and complex CDOs (Ferguson, 2010). Despite the inflated ratings, however, no serious actions were taken to regulate these agencies, even though Sarbanes-Oxley, a 2002 law that expanded federal oversight of corporations, contained a provision requiring a “commission study...regarding credit rating agencies” (U.S. Congress House, 2002). Part of what encouraged this “gaming of the system” was the stock-option-based incentive structure of bank executives, who were motivated to maximize stock prices and thus increase their compensation (Ferguson, 2010). They used various innovative methods, such as “creative accounting” (Morgenson & Rosner, 2012, pp. 100–101), to flout federal regulations and take enormous financial risks that would temporarily increase corporate profits but endanger their companies in the long run (Ferguson, 2010). Unfortunately, no rules were ever established to regulate this incentive structure.

3. The Catastrophe: The 2008 Financial Crisis

In 2008, following a collapse in the subprime mortgage market, many renowned investment banks and insurance companies imploded. The failure of the financial industry triggered a collapse of the real economy, plunging America into a large-scale recession.

3.1 The Housing Bubble and Subprime Loans

In the 1990s, Fannie Mae and Freddie Mac, two government-sponsored mortgage lenders, embarked on an ambitious mission to expand homeownership. The result was the single largest housing bubble in history. Fannie Mae CEO, James Johnson, successfully lobbied the government to lower Fannie Mae’s underwriting standards from at least a 20 percent down payment to one of only 5 percent. Also, in a program called Alternative Qualifying, Fannie Mae relaxed numerous lending rules, such as analyzing the risk of a potential borrower (Morgenson & Rosner, 2012, pp. 26, 52–53). These practices encouraged the blossoming of the subprime market, which helped many Americans buy their first home, but also generated enormous risks that contributed to the 2008 financial crisis.

3.2 Doomsday

In 2006, when the housing bubble burst, house prices dropped, and interest rates began to rise; a wave of defaults and foreclosures soon hit the United States, causing huge losses among subprime lenders and CDO investors (Amadeo, 2019). Demand for CDOs halted abruptly, and in July 2007, two of Bear Stearns' hedge funds went bankrupt. The high-leverage ratios of Bear Stearns now dragged the bank to the verge of bankruptcy. On March 17, 2008, Bear Stearns was sold to JP Morgan at \$2 a share, a deal backed by a Federal Reserve bailout (Godoy, 2008). On a September weekend that same year, Henry Paulson, now Secretary of the Treasury, and Timothy Geithner, president of the New York Federal Reserve, called an emergency meeting with CEOs of major banks to rescue Lehman Brothers and Merrill Lynch (Ferguson, 2010). Both of these banks had deep financial troubles, a result of some of their previously lucrative securities becoming worthless with the subprime market crash. As a result of that meeting, Merrill Lynch was acquired on Sunday, September 14, 2008, by Bank of America. But when Barclays, a British bank, tried to buy Lehman Brothers, the deal was rejected by the British government. The British government wanted a financial guarantee from the US government to ensure any acquisition would not potentially destabilize the British financial sector. But unlike what he did with Bear Stearns, Paulson refused the demand for a guarantee, so the deal fell apart (Ferguson, 2010). Following this setback for Lehman Brothers, the Federal Reserve demanded the bank file for Chapter 11 bankruptcy before midnight of September 14 to calm the markets hurt by its falling stock prices. Lehman's CEO Richard S. Fuld objected, warning that the bankruptcy would only disrupt the markets further (Ferguson, 2010). On September 15, Lehman Brothers filed for bankruptcy. In the meantime, banks such as Morgan Stanley and even Goldman Sachs had massive capital deficits as well.

The failure of Lehman Brothers triggered the crash of the commercial paper market, which put a halt to many business operations across the US and forced massive layoffs (Ferguson, 2010). At the time, insurance giant AIG had sold many CDSs to investment banks, expecting that a massive wave of defaults was impossible. However, the huge failure of underlying CDOs meant that AIG was unprepared to pay off all the CDSs it had sold. This nearly caused the company to go bankrupt, which paralyzed many insurance-backed businesses, including the airline industry (Ferguson, 2010). The failure of Wall Street ultimately crippled

Main Street, as the unemployment rate rose to over 10 percent, and foreclosures reached 6 million by early 2010 (Ferguson, 2010). The US economy had been nearly decapitated.

4. Rescue, Remedy, and New Financial Regulations

During and after the financial crisis, the government offered enormous bailouts and introduced new regulations to prevent the same mistakes from happening again.

4.1 TARP and PPIP

On September 7, 2008, Henry Paulson announced the takeover of Fannie Mae and Freddie Mac, both of which were about to collapse (Ferguson, 2010). On September 16, the Federal Reserve agreed to give AIG an \$85 billion loan and took over the distressed company to prevent a total implosion of the US economy (Andrews, 2008). On September 18, Paulson and Federal Reserve chairman Ben Bernanke asked Congress for a \$700 billion bank bailout to forestall a “catastrophic economic collapse” (Ferguson, 2010). About two weeks later, on October 4, President Bush signed the Emergency Economic Stabilization Act of 2008 (U.S. Congress House, 2007), which set up the Troubled Asset Relief Program (TARP) to purchase toxic assets—namely, now-worthless CDOs and CDSs—from the troubled banks (Kenton, 2019c). This included the bailout of AIG, which ultimately “cost taxpayers over [\$150 billion]” (Ferguson, 2010).

After Obama became President of the United States, his Treasury instituted the Public-Private Investment Program (PPIP) to increase the liquidity of the ‘legacy’ assets held by banks (Stiglitz, 2010, p. 123). Although PPIP’s stated purpose was to complement TARP by buying legacy assets from financial institutions (Chen, 2018), Nobel Prize economist Paul Krugman charged that its actual purpose was to subsidize shareholders, asset managers, and creditors through non-recourse loans, which would encourage extreme bidding of assets (Krugman, 2009a).

4.2 President Obama and the Dodd-Frank Act of 2010

In 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. Dodd-Frank further empowered the Federal Deposit Insurance Corporation with new responsibilities, gave the Federal Reserve new powers to regulate banks, created the Consumer Financial Protection Bureau, and repealed the regulatory exemption for the derivatives industry (U.S. Congress House, 2009).

One specific provision in the Dodd-Frank Act was the Volcker Rule, which, much like Glass-Steagall, prevents banks from using depositor money to advance corporate profits and prohibits banks from owning, investing in, or sponsoring hedge funds and equity funds (Chen, 2019).

Although Dodd-Frank introduced many important reforms, some have criticized the law for neither fully restoring the financial regulatory barriers which once protected America, nor preventing the increasing concentration of the financial industry into a few big banks (White, 2018).

5. Conclusions and Future Regulations

In summary, financial deregulation and the refusal to enact new, modern rules contributed significantly to the 2008 financial crisis. Since the stock market crash of 1929, government regulations had protected America from financial crises for decades. Starting from the 1980s, the deregulation movement overturned or relaxed many regulations. Pro-deregulation advocates argued that the financial regulations needed to be loosened, so American banks could remain globally competitive. They reassured the public that the financial industry could be trusted to regulate itself and that banks would only invest in low-risk securities after regulations were relaxed. Financial deregulation stimulated impressive short-term economic growth and improved corporate efficiency. In the long run, however, deregulatory policies created more risks and problems than benefits. With the repeal of the Glass-Steagall Act of 1933 and the McFadden Act of 1927, commercial, insurance, and investment banks were allowed to merge, consolidate, and expand across state lines. This dramatically increased the size of banks, and some became 'too big to fail'. With the removal of the Net Capital Rule in 2004, banks were given the green light to increase their leverage ratio and to pursue short term profits at the expense of long-term stability. With the reluctance to regulate the subprime and derivatives markets, bubbles were created in these markets. Also, due to lack of regulation, unethical business practices by mortgage lenders and bank executives increased. There were also conflicts of interest within credit rating agencies. All these factors played important roles in the greatest financial disaster in modern history, which imploded the US economy in 2008. Since then, people have been questioning how best to craft new regulations that are both effective and well-suited for the modern world of banking.

Several new proposals have been put forward for reforming the financial sector for the future. Even after many years, some of them are still under debate. The following is a short list:

- **The 21st Century Glass-Steagall Act**

A prominent new barrier proposed is the 21st Century Glass-Steagall Act. This law intends to prevent FDIC insured deposit banks from associating with securities or insurance banks, prohibits “foreign banks from engaging in nonbanking activities” in America, and restricts national banks in general from participating in nonbank activities like purchasing securities (U.S. Congress Senate, 2017). Although the law has received criticism for placing unfair burdens on the US when the ‘right regulation’ is good enough, it would go a long way to preventing banks from accumulating enough wealth to become “too big to fail”.

- **Reform of Incentive Payment Structure**

Another proposal has been to address the incentive payment plans of corporate executives. The current ‘merit-based’ system of incentive payment focuses on rewarding management for short-term profits. This means that if the short-term gain in a company ran diametrically in contrast to long term sustainability, executives, particularly on Wall Street, would sacrifice the latter to have more of the former and more generous executive compensation (Ferguson, 2010). Instead, some advocate for a new type of incentive payment system that rewards executives based on returns when adjusted for risk. This system would not only consider how much wealth a financial manager could bring in for the company but evaluate whether those short term gains could be translated into prosperity in the long run (Bhatnagar, 2017). Even though this proposal has not been seriously considered in Congress, other attempts to strictly regulate executive compensation have been passed, such as the Capital Requirements and Bonuses Package, which was adopted by the European Parliament on July 6, 2010 (Oxford Analytica, 2010).

- **Regulating Credit Rating Agencies**

Although the Dodd-Frank Act’s Subtitle C of Title IX addresses maintaining the accuracy of credit rating agencies (U.S. Congress House, 2009), people have criticized the provisions for being only perfunctory (Ferguson, 2010). Many individuals are concerned that the SEC does not address the issuer-pay model of credit rating, wherein bank companies pay credit rating agencies to rate securities. Under this system, the rating agencies thus feel obligated to “go easy” on the bank’s securities, lest they lose the bank’s patronage. One popular proposal is that the SEC,

which is in charge of regulating credit rating agencies, should more zealously scrutinize these agencies, given “their large contributions to the financial crisis” (Warren, 2019).

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