

Deregulation Should Not Be Blamed for the Financial Crisis

BY JOHN A. WEINBERG

The financial crisis, quite understandably, has motivated a broad re-examination of our approach to financial regulation. Ideas for regulatory improvements have come from academics, the financial industry, and Congress. Many commentators have argued that regulatory shortcomings leading up to the crisis were the direct result of deregulation implemented over the preceding decades. One particular step in this process of deregulation was the repeal of the Glass-Steagall Act.

Glass-Steagall became law in June 1933 as part of the legislative response to the Great Depression. This law required that the investment banking activities of underwriting and dealing in securities could not be conducted in the same companies as the commercial banking activities of taking deposits and making loans. The motivation for this law was a widespread perception that the combination of those activities had led to conflicts of interest which resulted, for instance, in questionable securities being sold to investors so that banks' borrowers could continue to service their bank loans. While this separation became weaker over time, many point to the Financial Services Modernization Act of 1999, better known as the Gramm-Leach-Bliley Act, as the action that "repealed" Glass-Steagall.

The crisis of 2007 and 2008 also involved the interaction of securities and banking, although in a somewhat different form. Securities created by pooling loans, particularly mortgage-backed securities, were at the heart of the crisis. This process of securitization includes activities that resemble both traditional commercial banking (making loans) and traditional investment banking (underwriting and dealing in securities). While many of the riskiest mortgages in the securitization market were originated by lenders outside the commercial banking system, the largest commercial banks still suffered significant losses on subprime loans. These banks suffered losses because they had provided implicit or explicit commitments of liquidity support to off-balance sheet entities involved in subprime loan securitization.

In retrospect, it has become apparent that this process led to an overexpansion of risks related to mortgages and other lending. Would this expansion have been possible before the weakening of the separation between investment and commercial banking? At the time Gramm-Leach-Bliley was passed, many of the securities activities that were tied most closely to the current financial crisis were already permissible for banks and bank-affiliated companies. So, in this sense, the legislation did not significantly alter the powers the banks had. Of course, one might respond that before Gramm-Leach-Bliley the separation created by Glass-Steagall had already been weakened considerably. This weakening had occurred due to regulators' rulemakings and

court decisions. As a result, during the 1980s and 1990s commercial banks were offering many investment banking services and investment banks were offering many commercial banking services. But even so, it was not so much the mixing of activities that led to the problems in the expansion and management of risk. Rather, it was the ways in which some large financial firms, whether in commercial or investment banking, approached their exposures to an event that, at the time, looked relatively unlikely.

The securitization of assets like mortgages brings with it some benefits of risk diversification by bundling the credit made to a large number of borrowers. The risk that remains is aggregate, undiversifiable risk, like that associated with a change in interest rates or a broad decline in the value of real estate. The latter, in fact, turned out to be the risk that imperiled our financial system.

Markets are usually able to allocate large aggregate risks to those firms best equipped to hold those exposures. One factor that might give an individual firm a comparative advantage at holding such risks is access to a reliable source of emergency liquidity. The financial safety net that includes deposit insurance and access to Fed lending did this by offering implicit and explicit commitments of liquidity to issuers of mortgage-backed financial instruments. When the markets for those instruments turned sour, the risks came back onto the books of the banks. Investment banks, especially large firms which may have benefited from a presumption that they would receive official support in a crisis, may have similarly been advantaged when holding exposures to seemingly unlikely bad events, such as a decline in home prices.

This dynamic of aggregate risks being concentrated in the hands of large institutions is independent of which firms are allowed to engage in which activities. It comes instead from the way in which emergency financial support is provided by the public sector. The existence of such support creates the need for regulatory oversight and, in particular, for regulatory attention to aggregate risks that tend to be concentrated in large institutions, the failure of which can produce financial panic.

The regulatory agencies are undertaking efforts to improve this aspect of oversight, and some components of reform proposals are aimed at aggregate or systemic risks. This is an important direction for improvements to take. Yet, improvements to the way we constrain the financial safety net are needed too. These changes would make a greater contribution to financial stability than rebuilding the Glass-Steagall wall. **RF**

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