Financial Deregulation
And the Dodd-Frank Act

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Reuters

Donald Trump's campaign promises to cut taxes, increase spending on infrastructure, and undertake financial deregulation are happening and have contributed to a partial hike in U.S. consumer confidence levels and the markets. Specifically, the prospect of financial deregulation helps explain why, since the election, the New York Stock Exchange has risen more than 10 percent and made huge profits for financial firms, reaching historic highs, such as in the case of the Dow Jones Industrial Average, which topped 21 000 points in March of this year. However, the effects will be felt again in the not-too-distant future and, as Cornell University legal expert Saule Omarova says, "Financial reform is like a big onion. The more layers you peel off, the harder you cry."[1]

Last March, Trump signed an executive order telling the Treasury Department to review and assess current financial regulations, including the Dodd–Frank Wall Street Reform and Consumer Protection Act signed into law by Barack Obama after the 2007-2008 financial crisis. The idea is to investigate whether these rules are reasonable and operational for participants in financial markets. The critics of Dodd-Frank see this as a good thing. They consider it an obstacle that limits and smothers the U.S. economy, particularly their profits. However, we should remember that the law was created due to the speculative excesses by large financial corporations that had been operating almost completely unrestrictedly in the markets. Its aim was to reduce risky practices and increase capital requirements for banks and the liquidity cushions they had to maintain for greater security. This law attempted to regulate and sometimes limit operations with derivatives, monitoring the dangerous intertwining of financial institutions, in addition to scrutinizing and regulating the largest, most complex institutions. In general, Dodd-Frank attempted to reduce the interdependence of U.S. financial institu-

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tions, limiting banks' exposure and credit risk through their subsidiaries.

The regulating-deregulating process is basically a political power game of interests. I should mention that the attempts to deregulate are by no means new in the history of U.S. financial services. We must not forget that some of these episodes led to grave financial crises in which society as a whole was seriously affected and the government had to implement huge bailouts of the big banks through the Federal Reserve (the Fed) on the taxpayers' dime at a high social and political cost.

Review of the Deregulation Process

This is why it is pertinent to briefly review that process in the United States, to understand its motivations, nature, and the interactions of the increasingly deregulated, integrated financial markets and the commercial banking system.

After the 1929 crisis, the main concern of U.S. financial system regulators focused on maintaining the health of financial institutions and the stability of the financial system as a whole. The Glass-Steagall Act of 1933 prohibited commercial banks from underwriting securities and other investment activities and/or to merge or affiliate with brokers-dealers; it clearly separated commercial banks (that offered credit) and investment banks (that dealt in financial markets). However, over the years, the competition among the different institutions and sectors began to change these two political objectives, since tensions managed to gradually erase the distinction between institutions and products.

Starting in the 1970s, the emergence of huge financial corporations accelerated as their participation in the domestic financial market increased as did their operations overseas. The process of concentration of these large organizations began to intensify in the mid-1980s with the threat of the failure of a banking giant, the Continental Illinois National Bank and Trust Company. This brought into question the way in which the regulatory institutions had been operating, in particular the Federal Deposit Insurance Corporation (FDIC). The center of the controversy was whether or not to rescue the non-banking financial assets that form a large part of commercial banks' balance.

Deregulation, globalization, and the concentration and consolidation of financial services were the result of the development of financial innovation, more flexible legislation in this area, and sharpened competition between commercial banks and other institutions in the sector. We should remember that banking regulation has always been a power play among banking regulators. This is how the sector moved toward financial conglomerates and the creation of banks that were "too big to fail."[2] It also transited toward the consolidation of a large financial services industry with close links among the different companies and commercial banks moving outside their traditional business areas without regulations acting as an obstacle.

Gradually, bank holding companies (large financial corporations) were allowed to issue securities, including bonds. But it was beginning in the mid-1980s that the Federal Reserve and the Office of the Comptroller of the Currency began to relax restrictions to allow full participation of commercial banks in investment and insurance activities. This led to the consolidation of this financial system and the creation of the "too-big-to-fail" banking giants. The problem this posed was the potential failure of these financial conglomerates, consolidating in the mid-1980s with a wave of mergers and acquisitions with the help of the FDIC.

This financial concentration brought into question the effectiveness of this institution's regulatory activity and alerted to the potential financial disaster if any of these huge conglomerates failed. Jane D'Arista mentions that in those years less than 1 percent of all banks and insurance companies held 50 percent of all financial sector assets.[3] This tendency to concentrate did not stop; quite to the contrary, in later decades, the number of mergers actually rose, particularly because banking failure regulatory practices, "supervisory mergers," forced institutions in trouble to merge with other larger institutions.

During the 1980s, financial markets became a source of liquidity and profits through new financial instruments. Investment banks' strategies fostered the growth and domination of these markets, thus contributing to changes in the financial structures of the U.S. economy, which went from handling credit to the use of financial markets.

The consolidation of financial services took place as a function of a change in regulations that facilitated a way of increasing profits and dealing with competition. Many of the changes in this system in the U.S. were led by the development of financial markets and, to a lesser extent, due to changes in economic policy. These developments included technological progress, innovations, and improvements in financial conditions, excess capacity in some markets, and the consolidation of markets through deregulation and institutional change. The lifting of restrictions on banking and financial competition was a powerful force behind the consolidation of services, and also transformed the way the markets and institutions operated to seek higher profits.

The dividing line between commercial banks, investment banks, and insurance companies began to disappear long before Congress passed the Gramm-Leach-Bliley Act in 1999.[4] The integration of commercial banking with investment banking created a very significant market force; nevertheless, consolidation and integration also increased systemic risk[5] and expanded safety nets significantly at a high cost to taxpayers.[6]

The Glass-Steagall Act maintained the separation of commercial and investment banks. In 1999, the Gramm-Leach-Bliley Act repealed it to allow the merger of financial institutions of different kinds, under pressure from politicians, regulators, and bankers who were all fighting for their own interests. Companies like Merrill Lynch pressured for the New York Stock Exchange to relax its rules and allow its members to go public to raise new capital. The 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act came into being after a decade of undermining local control and formally allowed banks to open branches in more than one state. The gradual elimination of Glass-Steagall regulations and the establishment of quite permissive regulations gave rise to the proliferation of what have been termed "esoteric" activities, that is, hidden, or at the very least non-transparent and presumably illicit financial activities.

Although some believe that self-regulated, competitive markets inhibit risk, we can observe the precise opposite: financial asset markets have shown a growing tendency to create perverse incentives to assume huge risks and achieve high yields. One example of this is the inordinate growth of derivatives, which are part of the aforementioned financial innovation: complex instruments that circulate almost exclusively in a closed circuit of large conglomerates and are handled mainly by investment banks, hedge funds, and multinational corporations very closely tied to each other through their balance sheets.

I will look more closely at the case of Lehman Brothers. Despite being one of the world's largest investment banks, in September 2008, it failed, considered the biggest failure in history, when it declared US$613 billion in liabilities and about US$700 billion in assets. This scandal is comparable to the Enron crisis and reached to the highest levels of the White House. Lehman Brothers was hard hit by the sub-prime mortgage crisis. Its huge exposure brought it gigantic losses that it tried to hide through an accounting mechanism that involved listing toxic assets (which cannot be sold after exposing their holders to massive losses) as normal assets to ensure their accounts did not reflect US$50 billion in "bad assets" or "junk bonds." Its failure set off the biggest financial crisis since the 1930s.

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Conclusions

The big banks, investment funds, institutional investors, and, in particular, investment banks have been fundamental agents in the transformation and development of capitalism led by finance and based in deregulation. These organizations operate according to a logic of growing profitability and constantly evolving financial innovations, like derivatives, which require deregulation and scanty supervision.

Furthermore, financial speculation is linked to the growth of global financial conglomerates and shadow banking associated with the credit rating agencies. Traditionally, commercial banks had been the main providers of liquidity, but over the last three decades, deregulation has meant that institutions based in financial markets have participated in this big business.

Shadow banks have the ability to create liquidity similar to the way commercial banks do, although without being regulated. Shadow banks include a wide variety of leveraged financial intermediaries that participate in the process of creating liquidity through their access to financial markets and the instruments they handle, particularly unregulated derivatives. This makes them particularly and exponentially dangerous.

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Regulations like Dodd-Frank get in the way of these actions and operations. That is why some people are interested in revoking it. Nevertheless, financial innovation implies an unfettered rise in liquidity through banks' increased capacity to create money in their quest for profitability with no thought to the risks. This is the main reason banking and financial activities must be regulated.

Finally, Trump's mandate to revoke Dodd-Frank will certainly speed up another crisis of even more devastating scope and consequences than the last one. In fact, problems are already reemerging in the banks that are highly exposed in derivatives, and that is what caused the 2007-2008 financial crisis. VM

Further Reading

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Notes

[1] Saule Omarova, "The Quiet Metamorphosis: How Derivatives Changed the Business of Banking," *University of Miami Law Review* vol. 63, 2009, pp. 1041-1110.

[2] These are large banks considered important for the entire financial system due to the risk that their failure could represent. This was the case of the financial collapse of Lehman Brothers in September 16, 2008.

[3] Jane D'Arista, "Financial Concentration," Wall Street Watch, working paper no. 3, August 2009, http://www.wallstreetwatch.org/working_papers/Financial_Concentration.pdf.

[4] The Gramm-Leach-Bliley Act (GLB), also known as the Financial Services Modernization Act of 1999, repealed the Glass Steagall Act.

[5] The effects of systemic risk can impact risk for individual systems, particularly those of large institutions with credit or liquidity difficulties, and transmit it to the rest of the system. If an individual institution's risk is high, it increases the possibility of its failing or not complying with its payment obligations, exposing other institutions to the risk, runs on banks, or problems in the stock market.

[6] Competition among banks and other financial institutions was limited by certain restrictions on the kind of financial services that each bank could offer, such as insuring deposits. In addition to insuring deposits, the FDIC federal safety net includes federal intervention to head off crises or the failure of the banking system.