

**Title:** The Financial Services Modernization Act of 1999

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## I. Executive Summary

The Financial Services Modernization Act of 1999, otherwise known as the Gramm-Leach-Bliley Act (“GLBA”), repealed banking regulations from the 1930s – the Glass-Steagall (1933) and the Bank Holding Company Act (1956). Those laws prevented the merger of commercial banks, stock brokerage companies, and insurance companies. GLBA also introduced the Financial Privacy Rule and the Safeguards Rule, which required financial institutions to explain their information-sharing practices to their customers and to safeguard sensitive data, respectively. In enacting GLBA, Congress aimed to “modernize” the financial services industry.

By annulling Glass-Steagall and Bank Holding Company Act protections, GLBA encouraged consolidation in the financial services industry. Financial services companies created financial holding companies, which were now overseen by the Federal Reserve.<sup>1</sup> Experts continue to debate the lasting effects of this act. Critics often argue that GLBA contributed to the financial crisis of 2008 by deregulating the banking sector and removing restrictions on commercial bank securities activities. GLBA supporters contend that not passing GLBA, or later repealing it, would not have prevented the financial crisis, which resulted from bad investments by large, poorly capitalized financial institutions.<sup>2</sup>

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<sup>1</sup> Jolina C Cuaresma. "The Gramm-Leach-Bliley Act." *Berkeley Technology Law Journal* 17, no. 1 (2002): 497-517. Accessed March 21, 2020.

<sup>2</sup> See Oonagh McDonald (2017), Lawrence White (2010), and Joseph Karl Grant (2010).

## **II. Introduction**

President Bill Clinton signed the Financial Services Modernization Act into law on November 12, 1999. Sen. Phil Gramm, Rep. Jim Leach and Rep. Thomas Bliley sponsored the bill, and together, became its namesake. Known as the Gramm-Leach-Bliley Act (“GLBA”), GLBA repealed aspects of the Glass-Steagall Act (1933) and the Bank Holding Company Act (1956), removing barriers that previously separated banking companies, securities companies and insurance companies, and that prohibited commercial banks from underwriting most bonds, equities, and insurance policies.<sup>3</sup> After passage of GLBA, financial holding companies (FHCs) were allowed to conduct these activities.

## **III. Policy Problem**

The Gramm-Leach-Bliley Act redesigned the financial regulatory structure that had been in place since the Great Depression. As a result of New Deal legislation, financial services—commercial banking, investment banking and insurance—had operated in independent institutional siloes since the Great Depression. By the mid-1980s however, the banking industry had begun to consolidate, as “the number of commercial banks in the US fell from 14,000 in 1984 to 9,000 in 1999.”<sup>4</sup> By 1999, financial integration was well underway, and Congress responded by passing GLBA. In addition, by 1999, financial integration was well underway and Congress responded by passing GLBA. In addition, GLBA aimed to allow US financial firms to become competitive globally.

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<sup>3</sup> Lifa Y. Huang, Wayne J. Lee, and Timothy Yeager. “The Impact of the Financial Services Modernization Act on Systemic Risk in Financial Institutions.” University of Arkansas, February 2017.

<sup>4</sup> Joe Mahon. “Financial Services Modernization Act of 1999, Commonly Called Gramm-Leach-Bliley.” Federal Reserve History, November 22, 2013.

To better understand the Gramm-Leach-Bliley Act, one must first examine the Glass-Steagall Act (1933) and the Bank Holding Company Act (1956). Glass-Steagall was signed into law during the Great Depression and required commercial banks and investment banks to be separate corporate entities. The Act prevented commercial banks from dealing in securities and banned investment banks' taking of deposits.<sup>5</sup> The Bank Holding Company Act complemented the Glass-Steagall Act, separating banking from "commerce," and prohibited multi-bank holding companies from extending their networks of separately chartered banks across state lines and from engaging in non-financial services activities.<sup>6</sup>

GLBA redesigned the regulatory structure by repealing aspects of Glass-Steagall and the Bank Holding Company Act. Legal scholar and former regulator Jolina Cuaresma explained that because "the regulatory structure developed through Glass-Steagall in such an ad hoc manner, . . . GLBA's reforms answer a long-felt need of coherence."<sup>7</sup> In fact, GLBA did not fundamentally change the nature of the "mixing" within the financial services sector; it simply extended what was already being practiced as a result of the gradual liberalization of the Glass-Steagall restrictions.<sup>8</sup> "Glass-Steagall barriers," another legal scholar has observed, "remained intact until the 1970s when expansion initiatives by commercial banks and investment banks eroded those barriers."<sup>9</sup> At that point, commercial banks began to offer various kinds of securities services to household and businesses, while investment banks undertook activities that "attracted business from both the assets side and the liabilities side of commercial banks' balance sheets."<sup>10</sup> Mortgage securitization, which began in the 1970s, meant that financial

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<sup>5</sup> Larry Neal, and Eugene N. White. "The Glass-Steagall Act in Historical Perspective." *The Quarterly Review of Economics and Finance* 52, no. 2 (2012): 104-13.

<sup>6</sup> James R. Barth, R. D. Brumbaugh, and James A. Wilcox. "Policy Watch: The Repeal of Glass-Steagall and the Advent of Broad Banking." *The Journal of Economic Perspectives* 14, no. 2 (Spring, 2000): 191-204.

<sup>7</sup> Jolina C. Cuaresma, "The Gramm-Leach-Bliley Act." *Berkeley Technology Law Journal* 17, no. 1 (2002): 497-517. Accessed March 21, 2020.

<sup>8</sup> Abdullah Al Mamun, Kabir M Hassan, and Van Son Lai. "The Impact of the Gramm-Leach-Bliley Act on the Financial Services Industry." *Journal of Economics and Finance* 28, no. 3 (2004): 333-47.

<sup>9</sup> Lawrence J White. "The Gramm-Leach-Bliley Act of 1999: a bridge too far? Or not far enough?" *Suffolk University Law Review*, Fall 2010, 940.

<sup>10</sup> *Ibid.*, pp. 940.

institutions could finance residential mortgages through the securities markets rather than through commercial banks.<sup>11</sup> Moreover, in the 1970s banks saw the deregulation of stock brokerage commission rates as an opportunity for entering the securities brokerage business.<sup>12</sup> In the 1980s and early 1990s, Congress loosened regulations regarding the amount of corporate securities that commercial banks could underwrite. During that period, increased opportunities for other routes of financing residential mortgages also emerged, due to the expansive mortgage activities of commercial banks and the securitization of residential mortgages by Fannie Mae and Freddie Mac.<sup>13</sup>

Therefore, Glass-Steagall's legal barriers eventually began to give way; by 1990, the largest banks were able to participate in almost all of the securities activities that they had engaged in before Glass-Steagall, much like banks in Canada and Europe, which continued as integrated financial concerns.<sup>14</sup> GLBA was the final piece of legislation to mark the end of Glass-Steagall regulation.

#### **IV. Policy Content**

GLBA repealed Sections 20 and 32 of the Glass-Steagall Act and aspects of the Bank Holding Company Act, effectively eliminating the walls of separation between key sectors of the financial services industry.<sup>15</sup> The Act also created new regulations for financial holding companies ("FHC")—the centerpiece of the act. Overall, GLBA aimed to foster financial integration for the benefit of both consumers and investors while safeguarding the soundness of the banking and financial systems.<sup>16</sup>

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<sup>11</sup> Ibid., pp. 940

<sup>12</sup> Ibid., pp. 941

<sup>13</sup> Ibid., pp. 941

<sup>14</sup> Jolina C. Cuaresma. "The Gramm-Leach-Bliley Act." *Berkeley Technology Law Journal* 17, no. 1 (2002): 497-517. Accessed March 21, 2020.

<sup>15</sup> Ibid., pp. 500

<sup>16</sup> Joe Mahon. "Financial Services Modernization Act of 1999, Commonly Called Gramm-Leach-Bliley." Federal Reserve History, November 22, 2013.

By repealing aspects of the Glass-Steagall Act, GLBA allowed commercial banks to affiliate with investment banks. After GLBA's enactment, commercial banks could transform their bank holding companies (BHCs) into financial holding companies (FHCs), which through non-bank subsidiaries could now engage in a wide range of financial activities, such as securities underwriting and dealing, insurance agency and underwriting activities, and merchant banking activities.<sup>17</sup> Thus, GLBA allowed for affiliations between commercial banks and firms engaged principally in securities underwriting, as well as interlocking management and employee relationships between banks and securities firms.<sup>18</sup> GLBA also authorized extended powers to national banks. Well-capitalized banks had the legal authority to underwrite and deal in municipal revenue bonds, while financial subsidiaries of a national bank could engage in many activities in which national banks still could not engage directly, such as securities underwriting and general insurance agency.<sup>19</sup>

Lastly, the Act "rewrote the financial rulebook" and gave the Federal Reserve new supervisory powers.<sup>20</sup> GLBA gave the Fed the role of "overarching, 'umbrella' regulator, with 'functional' regulation of specific financial activities by the Treasury Department's Office of the Comptroller of the Currency and myriad other agencies."<sup>21</sup> Henceforth, the Fed served as the FHC supervisor while other agencies oversaw distinctive activities occurring within each of the FHC's subsidiaries: "[T]he Fed and the Treasury Department's Office of the Comptroller

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<sup>17</sup> Abdullah Al Mamun, Kabir M Hassan, and Van Son Lai. "The Impact of the Gramm-Leach-Bliley Act on the Financial Services Industry." *Journal of Economics and Finance* 28, no. 3 (2004): 333–47.

<sup>18</sup> Oonagh McDonald. "The Repeal of the Glass-Steagall Act: Myth and Reality." Cato Institute, February 1, 2017.

<sup>19</sup> Abdullah Al Mamun, Kabir M Hassan, and Van Son Lai. "The Impact of the Gramm-Leach-Bliley Act on the Financial Services Industry." *Journal of Economics and Finance* 28, no. 3 (2004): 333–47; United States. Congress. Senate. Committee on Banking, H. *The State of the Banking Industry, S. Hrg. 110-959, March 4, 2008, 110-2 Hearing*, \*, 2010.

<sup>20</sup> Joe Mahon. "Financial Services Modernization Act of 1999, Commonly Called Gramm-Leach-Bliley." Federal Reserve History, November 22, 2013.

<sup>21</sup> Yoko Inque, and Nicholas Greifer. "The Emerging Impact of the Financial Services Modernization Act." *Government Finance Review*, October 2000.

of the Currency continue to have shared jurisdiction over banking, the Securities and Exchange Commission (SEC) regulates securities activities, and state governments oversee insurance.”<sup>22</sup>

## V. Stakeholder Analysis

The Gramm-Leach-Bliley Act impacted a wide range of stakeholders. Passage of the Act had immediate positive valuation effects for banks, brokerage firms, and insurance companies, with commercial banks being the most eager to take advantage, as it allowed them to expand their activities into the securities industry. Each of these types of financial institutions lobbied vigorously in favor of GLBA. Large banks in particular gained advantages, as “banks with strong capital positions benefited more from the expanded opportunities presented by GLBA’s passage.”<sup>23</sup> GLBA facilitated the creation of modern financial supermarket, whose sheer size created new concerns about systemical risks.<sup>24</sup>

Many economists nonetheless argued at the time that by allowing banks to diversify, the legislation would reduce bank risks, as firms could now spread their liabilities over multiple lines of uncorrelated business.<sup>25</sup> Critics, by contrast, worried that the failure of a FHC’s nonbank affiliate might bring down the entire organization and negatively impact counterparties and the broader economy.<sup>26</sup> Although scholars continue to debate GLBA’s impact on overall financial sector risk, passage of the statute did lead some institutions to expand their risk profile significantly.<sup>27</sup>

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<sup>22</sup> Ibid.

<sup>23</sup> Aigbe Akhigbe, and Ann Marie Whyte. “The Markets Assessment of the Financial Services Modernization Act of 1999.” *The Financial Review* 36, no. 4 (March 9, 2005): 119–38.

<sup>24</sup> Ibid., pp. 119–38.

<sup>25</sup> Lifa Y. Huang, Wayne J. Lee, and Timothy Yeager. “The Impact of the Financial Services Modernization Act on Systemic Risk in Financial Institutions.” University of Arkansas, February 2017.

<sup>26</sup> Yoko Inque, and Nicholas Greifer. “The Emerging Impact of the Financial Services Modernization Act.” *Government Finance Review*, October 2000.

<sup>27</sup> Lifa Y. Huang, Wayne J. Lee, and Timothy Yeager. “The Impact of the Financial Services Modernization Act on Systemic Risk in Financial Institutions.” University of Arkansas, February 2017.

## VI. Policy Relevance

Many scholars and politicians have identified the Gramm-Leach-Bliley Act as a major culprit in causing the Global Financial Crisis; given that both the 2016 Democratic and Republican party platforms called for reinstating Glass-Steagall, this view had bipartisan appeal.<sup>28</sup> However, several analyses since the crisis suggest this perception is unfounded, as GLBA, on its own, had little causal impact.

The main argument against GLBA is that it allowed certain banks to grow too big. Joseph Grant argues this point by depicting how large Citigroup and Bank of America grew following passage of GLBA.<sup>29</sup> Citigroup emerged in 1999 from the merger of Citicorp with Travelers Insurance, while Bank of America had become the largest mortgage lending and payment collection operation in the country by 2008, when it merged with Countrywide Financial. Neither mergers would not have been possible without GLBA.<sup>30</sup> Both banks were squeezed by the housing collapse and its impact on mortgage-backed securities, with Citigroup's market capitalization dropping from \$274 billion before the crisis to less than \$16 billion afterwards.<sup>31</sup> Through these examples, Grant argues that GLBA allowed for the formation of such "superbanks," that were "too big to fail." Another argument against GLBA highlights its authorization of commercial banks' engagement with securitization, which "transmitted the risk-taking culture of investment banking to commercial banks".<sup>32</sup>

Recent analyses have challenged these arguments. Lawrence White argues that GLBA marginally impacted the financial crisis, if at all.<sup>33</sup> And Oonagh McDonald contends that the

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<sup>28</sup> See Oonagh McDonald (2017), Lawrence White (2010), and Joseph Karl Grant (2010).

<sup>29</sup> Joseph Karl Grant. "What the Financial Services Industry Puts Together Let No Person Put Asunder: How the Gramm-Leach-Bliley Act Contributed to the 2008 - 2009 American Capital Markets Crisis," *Albany Law Review* 73, no. 2 (2010): 371-420

<sup>30</sup> *Ibid.*, pp. 408.

<sup>31</sup> *Ibid.*, pp. 409.

<sup>32</sup> Katherine Bentley. "The 2008 Financial Crisis: How Deregulation Led to the Crisis" (2015). Senior Theses.

<sup>33</sup> Lawrence J. White. "The Gramm-Leach-Bliley Act of 1999: a bridge too far? Or not far enough?" *Suffolk University Law Review*, Fall 2010, 937+.

crisis “was caused primarily by bad lending policies, which in turn led to the growth of the subprime market to an extent that neither the lawmakers nor regulatory authorities recognized at the time.”<sup>34</sup> On this view, the commercial banks and their holding companies that failed—or that other viable financial institutions had to acquire into order to avoid liquidation—did so because they functionally abandoned underwriting standards. These banks acquired and held large amounts of mortgage-backed securities, which pooled subprime and other risky loans. However, even under Glass-Steagall, banks were allowed to buy and sell mortgage-backed securities because regulators viewed these financial instruments as loans in a securitized form. Even with Glass-Steagall in place, the five large investment banks (Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Goldman Sachs) could have performed the same activities that got them in trouble during the 2008 financial crisis.<sup>35</sup> All of the problem activities—shadow banking, mortgage securitization, bank investment in and underwriting of mortgage-related securities, derivatives contracts tied to mortgage-related assets, and high financial leverage—were permissible for decades prior to the GLBA’s passage.<sup>36</sup> Therefore, GLBA’s defenders point the blame at other factors, like poor underwriting standards. The debate over Gramm-Leach-Bliley’s role in the crisis is ongoing, but one thing is certain – GLBA fundamentally altered the financial services industry in America.

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<sup>34</sup> Oonagh McDonald. “The Repeal of the Glass-Steagall Act: Myth and Reality.” Cato Institute, February 1, 2017.

<sup>35</sup> *Ibid.*

<sup>36</sup> Paul Mahoney. “Deregulation and the Subprime Crisis.” *Virginia Law Review* 104 (2018): 235–300.