



## Key Events in the De-regulation of the Financial Sector

Researched by Matt Sherman

### Usury and Banking Regulation before 1970

**Usury:** For the first 200 years in the life of the Republic (1776 until the 1970s), each state set laws regulating the maximum interest rate to be charged on loans – typically less than 8 percent per year. By the end of the 19<sup>th</sup> century, exploitative salary-lending, share-cropping, and on-credit company store lending circumvented these caps on usury in practice. But bank-based loans were still subject to state interest rate caps.

**Banking regulation in the U.S.:** The U.S. has always had a decentralized banking system. The Federal Reserve System, designed to control the monetary supply and prevent banking panics, was not established until 1914. Member banks are required to hold their capital reserves at the Federal Reserve and in return can borrow from “the discount window” at below-market interest rates.

Most U.S. banking regulations were established in the wake of the Great Depression – to prevent further crashes. The Glass-Steagall Act, passed in 1933, was the core of the architecture. It set caps on the interest rates banks could offer depositors (to prevent harmful interest rate wars), but gave special incentives to institutions that specialized in mortgage lending. It forced banks to choose between specializing in lending for individuals and businesses (commercial banks), and engaging in underwriting securities and trading stocks and bonds (investment banks) because of the inherent conflicts of interest involved in one institution doing both activities. It also established a system of deposit insurance for consumers, the Financial Deposit Insurance Corporation, which guaranteed that the government would reimburse deposits if a bank went bankrupt (to protect against panics and bank runs). The original cap for insured deposits was \$2,500, but this has been gradually raised through time to \$100,000 in 2008, when it was temporarily and then permanently increased to \$250,000.

The Federal Home Loan Bank Board was set up in 1933 to oversee savings and loan associations (also known as thrifts) that specialized in taking deposits and making mortgage loans. The Securities and Exchange Commission was set up in 1934 to oversee and protect against fraud in the buying and selling of stocks and bonds. The Commodity Exchange Act of 1936 set rules for the buying and selling of commodities and futures trading (it would become the Commodity Futures Trading Commission in 1974).

## Dismantling the Laws Governing Credit and Banking

- **1978** – The Supreme Court rules that banks operating across state lines can charge the interest rates allowed under the laws of the state where they incorporate to customers in other states. To attract banks to locate in their states, South Dakota and Delaware eliminate interest rate caps, effectively undermining state caps on usury everywhere else in the country. (*Marquette vs. First of Omaha*)
- **1980** – As Deposit insurance is increased from \$40,000 to \$100,000, interest rate ceilings on deposit accounts are lifted and thrifts are allowed to engage in new financial activities. (*Depository Institutions Deregulation and Monetary Control Act*)
- **1982** – Thrifts are almost entirely deregulated, allowing them to make commercial and real estate loans. (*Garn-St. Germain Depository Institutions Act*)
- **1982** – Non-standard mortgages like adjustable rates, 2-28 loans with teaser rates, and pay-option ARMs are allowed – instead of standard fixed-rate mortgages. (*Alternative Mortgage Transactions Parity Act*)
- **1986** – The Federal Reserve Board (comprised of the heads of banks) reinterprets Glass-Steagall to allow a bank to derive 5% of its gross revenue through investment bank activities – against the advice of Chairman Volker. (The wall between commercial banks and investment banks begins to break down.)
- **1987-1989** – **Savings and Loan Crisis** – After 1982, investors swarmed into the commercial real estate market and condominiums through unregulated S&Ls, creating a real estate boom. By 1986, only 56% of S&L assets were in home mortgages. The real estate market burst in 1985-6 as loans went bad. By 1987, thousands of thrifts failed, bankrupting the Federal Savings and Loan Insurance Corporation. The Resolution Trust Corporation and the newly created Office of Thrift Supervision were created to replace the FHLBB and sell off the bad loans. The debacle cost taxpayers \$210 billion in the end as half (1645/3234) of all thrifts died. (*Financial Institutions Reform and Recovery Act, 1989*)
- **1994** – The last restrictions on interstate banking and branch operations were removed. (*Riegle-Neal Interstate Banking and Branching Efficiency Act*)
- **1996** – The Federal Reserve under Greenspan reinterprets the Glass-Steagall Act, allowing bank holding companies to earn up to 25 percent of their revenues in investment banking.
- **1996** – The Supreme Court rules that state laws limiting credit card penalties and late fees on out-of-state banks are illegal. (*Smiley vs. Citibank*)
- **1999** – The Glass-Steagall Act is completely repealed, allowing the creation of “mega-banks” that are allowed to combine banking, securities trading, and insurance in one institution, with massive conflicts of interest. It exempts derivatives from regulation, including energy derivative trading – “the Enron Loophole.” (*Gramm-Leach-Bliley Act*)
- **2000** – Removes the authority of the Commodity Futures Trading Commission to regulate “over-the-counter” derivative contracts, including credit default swaps – the financial products that crash the economy in 2007-8. (*Commodity Futures Modernization Act*)
- **2004** – The SEC reduces the amount of capital investment banks have to hold in reserve to cover their loans, increasing their leverage and risk exposure.
- **2007-2009** – **Mortgage Crisis and Financial Meltdown** – Defaults on subprime loans reverberate through the entire mortgage market and the securities market, and freezing the financial system and generating the Great Recession.