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Meltdowns and Myths: Did Deregulation Cause the Financial Crisis?

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> *The trouble with the world is not that people know too little, but that they know so many things that aren't true.*
>
> —attributed to Mark Twain

Easy answers are seldom correct ones. That principle seems to be at work as the nation struggles to discover the causes of the financial crisis now rocking the economy. Looking for a simple and politically convenient villain, many politicians have blamed deregulation by the Bush Administration.

House Speaker Nancy Pelosi, for instance, stated last month that "the Bush Administration's eight long years of failed deregulation policies have resulted in our nation's largest bailout ever, leaving the American taxpayers on the hook potentially for billions of dollars."[1] Similarly, presidential candidate Barack Obama asserted in the second presidential debate that "the biggest problem in this whole process was the deregulation of the financial system."[2]

But there is one problem with this answer: Financial services were not deregulated during the Bush Administration. If there ever was an "era of deregulation" in the financial world, it ended long ago. And the changes made then are for the most part non-controversial today.

Basic Regulatory Structures Never in Doubt. In a literal sense, financial services were never "deregulated," nor was there ever a serious attempt to do so. Few analysts have ever proposed the elimination of the regulatory structures in place to ensure the soundness and transparency of banks. Simply put, the job of bank examiner was never threatened.

More typically, of course, the word *deregulation* has been used as shorthand to describe the repeal or easing of particular rules. To the extent there was a heyday of such deregulation, it was in the 1970s and 1980s. It was at this time that economists—and consumer activists—began to question many longstanding restrictions on financial services.

The most important such restrictions were rules banning banks from operating in more than one state. Such rules were largely eliminated by 1994 through state and federal action. Few observers lament their passing today, and because regional and nationwide banks are far better able to balance risk, this "deregulation" has helped mitigate, rather than contribute to, the instability of the system.

Gramm–Leach–Bliley and Beyond. The next major "deregulation" of financial services was the repeal of the Depression-era prohibition on banks engaging in the securities business. The ban was formally ended by the 1999 Gramm–Leach–Bliley Act, which followed a series of decisions by regulators easing its impact.

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While not without controversy, the net effect of Gramm–Leach–Bliley has likely been to alleviate rather than further the current financial crisis.

In fact, President Bill Clinton—who signed the reform bill into law—defended the legislation in a recent interview, saying, "I don't see that signing that bill had anything to do with the current crisis. Indeed, one of the things that has helped stabilize the current situation as much as it has is the purchase of Merrill Lynch by Bank of America, which was much smoother than it would have been if I hadn't signed that bill."[3]

In 2000, Congress also passed legislation that, among other things, clarified that certain kinds of financial instruments were not regulated by the Commodity Futures Trading Commission (CFTC). Among these were "credit default swaps," which have played a role in this year's meltdown. Whether this law constituted "deregulation" is not clear, since the pre-legislation status of these instruments was uncertain. Nor is it a given that CFTC regulation of their trading would have avoided the financial crisis. In fact, many policymakers, including Clinton Treasury Secretary Robert Rubin, argued that their regulation would do more harm than good.

In the nine years since that legislation—including the eight years of the Bush presidency—Congress has enacted no further legislation easing burdens financial services industry.

Regulatory Agency Trends. But what of the regulatory agencies? Did they pursue a deregulatory agenda during the Bush Administration? Again, the answer seems to be no.

In terms of rulemaking—the promulgation of specific rules by regulatory agencies—the Securities and Exchange Commission (SEC) is by far the most active among agencies in the financial realm. Based on data from the Government Accountability Office, the SEC completed 23 proceedings since the beginning of the Bush Administration that resulted in a substantive and major change (defined as an economic effect of $100 million or more) in regulatory burdens. Of those, only eight—about a third—lessened burdens.[4] Perhaps surprisingly, the Bush record in this regard is actually less deregulatory than that of the Clinton Administration, which during its second term lessened burdens in nine out of 20 such rulemaking proceedings.

Other financial agencies have been far less active in making formal rule changes. The Federal Reserve reports five major rulemakings in the database since 1996—four of which were deregulatory. The only rule change reported by the Federal Deposit Insurance Corporation and the Controller of the Currency is the 1997 adoption of new capital reserve standards, an action with mixed consequences.

Of course, much of the work of regulators takes place in day-to-day activities rather than in formal rulemaking activities. For that reason, it is also helpful to look at the budgets of regulators.

These also show little sign of reduced regulatory activity during the Bush years. The total budget of federal finance and banking regulators (excluding the SEC) increased from approximately $2 billion in FY 2000 to almost $2.3 billion in FY 2008 in constant 2000 dollars. The SEC's budget during the same time period jumped from $357 million in 2000 to a whopping $629 million in 2008. During the same time period, total staffing at these agencies remained steady, at close to 16,000.[5]

1. Laura Litvan and Brian Faler, "Congress Pushes for Bigger Role in Resolving Financial Crisis," Bloomberg.com, September 16, 2008, at *http://www.bloomberg.com/apps/news?pid=20601103&sid=aNQo2I5pPjdA&refer=us* (October 21, 2008).
2. "Transcript of Second McCain, Obama Debate," CNNPolitics.com, at *http://www.cnn.com/2008/POLITICS/10/07/presidential.debate.transcript* (October 21, 2008).
3. Maria Bartiroma, "Bill Clinton on the Banking Crisis, McCain, and Hillary," *Business Week*, September 24, 2008, at *http://www.businessweek.com/print/magazine/content/08_40/b4102000409948.htm* (October 21, 2008).
4. Based on the author's individual review of each rulemaking; see GAO Federal Rules Database at *http://www.gao.gov/fedrules*. Totals include all SEC proceedings, not just those specifically affecting financial services firms or stock market trading. For an analysis of rulemaking trends across all agencies, see James L. Gattuso, "Red Tape Rising: Regulatory Trends in the Bush Years," Heritage Foundation *Backgrounder* No. 2116, March 25, 2008, at *http://www.heritage.org/research/regulation/bg2116.cfm.*

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A False Narrative. In the wake of the financial crisis gripping the nation, it is tempting to blame "deregulation" for triggering the problem. After all, if the meltdown were caused by the ill-advised elimination of necessary rules, the answer would be easy: Restore those rules.

But that storyline is simply not true. Not only was there was little deregulation of financial services during the Bush years, but most of the regulatory reforms achieved in earlier years mitigated, rather than contributed to, the crisis.

This, of course, does not mean that no regulatory changes should be considered. In the wake of the current crisis, debate over the scope and method of regulation in financial markets is inevitable and, in fact, necessary. But this cannot be a debate over returning to a regulatory Nirvana that never existed. Any new regulatory system would be just that—complete with all the uncertainty and prospects for unintended consequences that define such a system. Policymakers must not pretend otherwise.

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5. Veronique de Rugy and Melinda Warren, "Regulatory Agency Spending Reaches New Height: An Analysis of the U.S. Budget for Fiscal Years 2008 and 2009," Weidenbaum Center, Washington University in St. Louis, and Mercatus Center, George Mason University, August 2008.