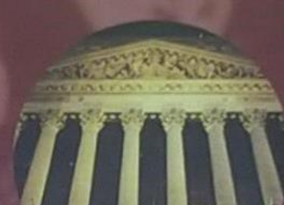
UNDUE INFLUENCE



How the Wall Street Elite Puts the Financial System at Risk

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In late 1999, a Republican congressman held a party in Washington to celebrate the passing of new legislation destined to have a profound effect on Wall Street and the entire financial industry in the United States. Despite the date on the law, the principle upon which it was based actually had been a cornerstone of the Reagan revolution 15 years earlier. The party seemed a bit late.

The centerpiece of the affair was a large cake bearing the message "Glass-Steagall, RIP, 1933–1999." Sipping champagne with one of the new law's sponsors, Jim Leach, Republican from Iowa, were Alan Greenspan, chairman of the Federal Reserve Board, and various Treasury officials and congressmen who had been instrumental in getting the new legislation passed, finally repealing the most talked about law of the twentieth century. After years of failed efforts and false starts, the Banking Act of 1933, as the Glass-Steagall Act was officially known, had been erased from the books and replaced by the Financial Services Modernization Act of 1999, the Gramm-Leach-Bliley Act. The champagne flowed and congratulations were offered by all. Never before had a law had so many detractors yet been so hard to effectively replace. The battle against Glass-Steagall began in the 1930s, revived in the 1960s, and became a major plank in the Republican platforms of the1980s. Ironically, it was not until the end of the century that it finally was repealed.

Since the dark days of the Depression, the Glass-Steagall Act had come to symbolize the fundamental cornerstone of what had become known as the social "safety net" erected by Congress to protect the American consumer. The law provided deposit insurance (left intact in 1999), allowed the Federal Reserve power to control bank interest rates (this power was repealed in 1980 and 1982), and most importantly, separated commercial and investment banking. This last part of the act was the most contentious, at least to the banks themselves. Any institution that accepted deposits from customers was not permitted to underwrite corporate stocks or bonds. The securities markets were considered too risky to use customer deposits for underwriting. The conditions that caused the Crash of 1929 were not going to be repeated again.

Over the course of the next 70 years, the Wall Street securities houses came to love Glass-Steagall because it created a virtually oligopoly among the major investment banks. They could not be owned by, nor could they own, commercial banks so the two sides of the banking business were indeed separated. The most lucrative side of what was known before 1933 as banking in general—investment banking—became the sole province of Wall Street, paying fat salaries and bonuses and fanning the occasional periods of speculative excess. The less lucrative, but steadier side remained commercial banking: taking deposits, making loans, and clearing checks. This was not exciting business and for years it had looked enviously at Wall Street. In a good year, all of those fat fees earned by investment bankers could easily exceed the less spectacular fees earned by banks doing their ordinary, run-of-the-mill business. If only the two sides could be rejoined.

The banking law did not survive the passing of the twentieth century, but other parts of the safety net did. The Securities Act of 1933 and the Securities Exchange Act of 1934 both remain as survivors of the 1930s because they aimed at reforming the practices of the securities industry rather than dividing it in the name of consumer protection. But the 1933 act had some gaping holes in it, acknowledged even when it was passed, that managed to remain plugged until the 1990s. Then, a wave of accounting fraud hit some of the "New Era" companies most conspicuous during the 1990s' bull market, and financial collapse followed. The unfortunate part of the financial meltdown was that it was caused in no small part by the deregulation that preceded it. The plaster had cracked, but it was the banks that were fueling the speculative fires of the mid- to late 1990s. The Gramm-Leach-Bliley Act officially was passed in 1999, but its effects had been felt for several years before since the Federal Reserve had allowed all of the deregulation mentioned in it to already occur on a de facto basis for almost 10 years. The market meltdown and scandals that followed were the most serious since 1929.

A larger question remained unanswered in the post–bear market debris left by a deregulated banking system: How was it possible that another series of scandals so similar to the one 70 years before could occur after decades of regulatory and legal developments? Part of the answer was obvious. Investors were still as gullible as ever, hoping to make a quick killing in the market. It was as if everyone had heard the old stories about the vast amount of wealth created during the nineteenth century and was only waiting for a New Era to begin. Many investors knew about the great American fortunes made in the Gilded Age and the Jazz Age. Now, new technologies were being used that could usher in a similar era of unforeseen riches almost a hundred years later. The frenzy that followed was natural. Cautionary voices were still heard in the marketplace, as they had been in the late 1920s, but not very loudly. The best that the Federal Reserve chairman could do was to call the period one of "irrational exuberance." The major policy tool at his disposal for calming the markets never was used. In 1930, the Fed was loudly blamed for not stopping the market roller coaster. In 2001, the worst condemnation it faced was that it had not seen the problem coming quickly enough.

The market collapse of 2001 was caused by a successful campaign by Wall Street and bankers in collaboration with like-minded individuals in the Clinton administration and Congress, many of whom with strong ties to the Street, to erase the Depression era laws constraining the markets. They inherited the sentiment from the generation of Republicans preceding them who wanted to abolish the banking laws in the name of free market ideology. When Congress passed the Gramm-Leach-Bliley Act in 1999, it represented one of the most successful campaigns by an odd combination of Republicans, New Democrats, and others ostensibly interested in free markets to put their imprint on the financial markets. The move also helped revise American history, adding to the ideological fervor of free marketeers, proving that the same capitalist system that defeated Soviet Communism could certainly get rid of some cumbersome Roosevelt era laws. Unfortunately, the result was the market collapse in the new century.

Activists opposed the deregulatory bill, fearing that large banks would ignore minorities and local communities in favor of corporate customers. In addition to Alan Greenspan, the Clinton administration broadly supported it, including Treasury secretary Robert Rubin, along with legislators from the other side of the aisle, including Senator Phil Gramm of Texas. It also had wide support from other parts of the financial services industry, especially among insurance companies and smaller financial companies, which assumed that it would allow them to be bought by larger banks. Once the bill was introduced, the juggernaut began for its quick passing.

While the details were being negotiated, a portent of things to come occurred. A Connecticut-based hedge fund—Long-Term Capital Management—began to totter in the summer of 1998. The fund, which used borrowed money to accumulate massive positions in bonds and stocks, was teetering on the verge of failure when the Fed stepped in to help it shore up its positions. The fund also claimed to have an all-star cast of academic and