

## ALAN GREENSPAN'S LEGACY: AN EARLY LOOK

### The Regulatory Record of the Greenspan Fed

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Alan Greenspan played an important role in shaping major changes in the structure and rules of financial regulation. Indeed, it is in this realm that Chairman Greenspan has made his most important contributions as an institutional innovator.

Just describing how the Federal Reserve made possible the expansion of commercial banks' powers to permit them to engage in investment banking could occupy this entire essay. That change occurred in several stages, beginning with the Fed's decision in 1987 to allow small inroads by banks into investment banking. Those changes created a favorable track record, which laid the groundwork for the Administration's and Congress's willingness to eliminate restrictions entirely in 1999 (a policy the Fed advocated in the 1990s). The growth in commercial banks' market share in investment banking has been dramatic. In 1992, only 10 percent of corporate debt and less than 1 percent of corporate equity flotations were underwritten solely or jointly by commercial banks. By 2002, that share had grown to 66 percent of debt and 36 percent of equity (Calomiris and Thanavut Pornrojngkool, 2006).

Can one identify a "philosophy of regulation" that underlies the regulatory advocacy of the Fed under Chairman Greenspan? Although the Fed's advocacy on various matters may appear somewhat contradictory or, at least, philosophically heterodox, the Fed has behaved in a manner that is remarkably predictable, once one takes account of the political arena in which both regulatory and monetary policy are made.

There is fairly straightforward logic to the

Fed's regulatory advocacy. To understand it, one must consider the Fed as a political player in the Washington drama; as a creature of Congress subject to its oversight; as a competitor with other regulators for influence within the financial services industry and within the political realm; and as a prioritizing agent that had to decide which battles (monetary or regulatory) to fight—when, and how hard.

One lesson of this overview of Fed regulatory advocacy during the Greenspan years is that the algorithm of Fed advocacy (the decision process that decides which position the Fed will advocate) has not changed, although some of the specific policy advocacy has. John Hawke (1988) wrote an evaluation of Chairman Paul Volcker's regulatory policy during his years at the Fed, which was presented at the 1988 ASSA Annual Meeting, and which describes an approach to Fed policy that is similar to the one suggested here. In that sense, Chairman Greenspan did not change the Fed; indeed, it is probably more accurate to say that his personal advocacy was changed by being at the Fed. But that does not imply an irrelevance to his leadership. What emerges from a review of Greenspan's regulatory record is an appreciation of his skill as a Beltway warrior, particularly with respect to his success in facilitating the geographical expansion of banks, broadening bank powers, and securing a prominent role for the Fed under the Gramm-Leach-Bliley Act of 1999.

#### I. The Fed's Regulatory Advocacy Algorithm: Ten Examples

In Table 1, I list ten of the main regulatory issues with which the Greenspan Fed has grappled. I categorize financial regulatory issues into four categories, according to my interpretation of the Fed's actions and the dominant motives for those actions. The first category is

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TABLE 1—EXAMPLES OF FED REGULATORY ADVOCACY

<i>Fed Advocacy of Beneficial Regulation</i>	
Interstate branching	The Greenspan Fed has been a much more vocal advocate of interstate branching than the Volcker Fed, owing to changes in the political landscape that allowed the Fed to support branching with little political risk, and with strong support from large banks.
Mergers and acquisitions	The Fed has supported large bank mergers. Although this has largely been beneficial, the merger of Fleet Bank and BankBoston Corp. shows that the Fed may be too willing to permit undesirable concentration of power to occur.
Fannie and Freddie post 2000	Once the political climate had become less risky, in cooperation with reform leadership by Congressman Richard Baker and the White House, the Greenspan Fed became a vocal proponent of reform, with strong support from large banks.
Investment banking powers	The Fed led the efforts to expand banking powers, particularly in the area of underwriting of corporate securities. This was done gradually, and at a time when large banks' international competitiveness was threatened, both of which limited the risk of a political backlash. This was strongly supported by the large banks.
<i>Not in the Interest of the Big Banks</i>	
Banking and commerce	The Fed opposes permitting nonbank firms (e.g., WalMart) to compete with banks, a position that supports the interests of large banks, and also limits regulatory competition with the Fed.
Minimum subordinated debt requirement for large banks	Despite widespread evidence supporting the view that such a requirement would boost prudential regulatory and supervisory discipline, some of which was produced by Fed staff, the Fed killed this initiative, due to opposition from the large banks.
<i>Too Politically Hot to Handle</i>	
Fannie and Freddie pre 2000	Fed officials and researchers were silent during the early phase of the reform efforts involving these Government Sponsored Enterprises because of the perceived political risks.
Community Reinvestment Act	Not an effective or efficient policy, yet the Fed does not oppose it because of the perceived political risks of doing so.
Real estate brokerage	Under Gramm-Leach-Bliley, the Fed shares with the Treasury Department authority to decide which activities qualify as permissible "financial" activities for financial holding companies. This places the Fed in a difficult position when there is strong political opposition to permitting entry. Despite the absence of any economic argument against permitting banks to act as real estate brokers, the Fed seeks to avoid the political fallout from supporting the effort.
<i>Fed Regulatory Power Play</i>	
Investment banking subsidiaries versus affiliates	The Fed sought to limit the ability of banks to operate securities subsidiaries and other subsidiaries of banks, as opposed to affiliates, in a largely unsuccessful power play against the Office of the Comptroller of the Currency.
Umbrella financial supervision by the Fed	The Fed succeeded in having itself appointed as an umbrella supervisor of financial holding companies under Gramm-Leach-Bliley.

labeled "Fed advocacy of beneficial deregulation." The remaining three categories include cases where the Fed has opposed beneficial regulatory policies, which I attribute to three reasons: "too politically hot to handle," "not in the interest of the big banks," or a "Fed regulatory power play" to boost its own political influence.

My proposed regulatory advocacy algorithm for the Fed is fairly simple. The Fed supports

beneficial deregulation so long as doing so does not (a) stir up significant political opposition to the Fed within Congress or the Administration, which might threaten its monetary policy independence, (b) harm the large commercial banks (which are key allies of the Fed in its political battles in Washington), or (c) undermine the Fed's competitive position vis-à-vis other regulators. Furthermore, these three constraints (opposition by politicians, opposition by big banks,

and erosion of Fed regulatory power) may lead the Fed not only to fail to support beneficial deregulation but also to actively support harmful regulation, or in the case of antitrust regulation, fail to enforce beneficial regulation (i.e., against undesirable anticompetitive mergers).

Underlying this categorization are two sets of substantive claims on my part: first, claims about what constitutes beneficial regulation, and second, claims about the interests that are served by supporting or opposing regulation. In the longer version of this paper (available from the author on request), I review in detail both sets of claims for the ten regulatory examples in Table 1 (interstate branching; mergers and acquisitions; Fannie and Freddie; investment banking powers; permitting investment banking subsidiaries versus affiliates; umbrella supervision by the Fed; banking and commerce; requiring large banks to issue subordinated debt; the Community Reinvestment Act; and real estate brokerage).

Two other aspects of Chairman Greenspan's record as a regulatory advocate warrant mention. First, he was a first-rate rhetorician. One of Chairman Greenspan's great skills was to shift the burden of proof to suit his argument. When he advocated deregulation (as in the case of expanding underwriting powers via affiliates), he argued that there was no clear evidence that deregulation would cause harm. When he opposed deregulation, he argued that there was no clear evidence that deregulation would *not* cause harm. In the case of permitting underwriting, he used gradualism to compromise with worrisome critics, and build a record of performance on which to base further relaxation of constraints. But he did not advocate gradualism and experimentation as a means to overcome uncertainties on the part of policymakers in other areas (notably with respect to permitting underwriting in subsidiaries, or with respect to allowing commercial firms to provide financial services). Chairman Greenspan knew how to overcome congressional fears of change when he wanted to. He also knew how to use Congress's fear of change as a tool to limit deregulation.

Second, the Gramm-Leach Bliley Act of 1999—the Chairman's moment of greatest triumph—was a double-edged triumph. On the one hand, Chairman Greenspan succeeded in his advocacy in the areas of broadening bank

TABLE 2—FINANCIAL REGULATION WITHIN OR OUTSIDE THE MONETARY AUTHORITY

Countries for which financial regulation authority lies <i>outside</i> the monetary authority	Countries for which financial regulation authority lies <i>within</i> the monetary authority
Australia	Argentina
Austria	Brazil
Belgium	Czech Republic
Canada	Egypt
Chile	Indonesia
China	Israel
Colombia	Jordan
Denmark	Kenya
Finland	New Zealand
France	Nigeria
Germany	Pakistan
Greece	Russia
Hungary	Saudi Arabia
India	South Africa
Ireland	United States
Italy	
Japan	
Luxembourg	
Mexico	
Netherlands	
Norway	
Peru	
Poland	
Portugal	
South Korea	
Spain	
Sweden	
United Kingdom	
Venezuela	

powers, securing umbrella supervisory authority, giving the Fed an ongoing role in deciding which activities would be permissible in financial holding companies, and limiting competition in banking from nonbanks (benefiting his big bank allies, while also limiting competition with the Fed in the regulation of banks). On the other hand, the Fed's new authority to determine permissible financial activities places it more squarely in the middle of political disputes that it does not really want to decide, because of the political risks of having to do so.

## II. The Case for Ending the Fed's Role as a Financial Regulator

During the 1980s and 1990s, the Fed's advocacy role was largely benign. Despite the fact that

the Fed was often on the wrong side in the ten areas reviewed in Table 1, it was on the right side of the most important controversies; and it made a difference in helping to win some important regulatory changes, most notably the consolidation of the banking industry and the expansion of bank powers into other financial areas.

In the future, the Fed is likely not to play a helpful role in resolving the most important regulatory issues. The most important desirable changes of the next decade will involve permitting the entry of nonbanks into banking, and developing stronger regulatory oversight to limit excessive concentration within the financial sector (not just for banks, but for ratings agencies, accounting firms, and other financial intermediaries). The Fed's political objectives and its alliance with large banks will limit its future effectiveness. Looking forward, there is an increasing benefit derived from removing regulatory authority from the Fed (a change that would align U.S. regulatory practice with the

rest of the financially developed world, as shown in Table 2). Although removing regulatory powers from the Fed has little political support today, Chairman Greenspan's departure may facilitate the renewed discussion of the need to separate monetary policy from regulatory policy, now that the Fed will be deprived of his personal stature, which has been used as a powerful weapon to defeat opponents of the Fed's agenda, and sometimes to prevent beneficial reform.

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