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Financial and Economic Crisis – Law Firms

Glass-Steagall – A Phoenix About To Rise Again?

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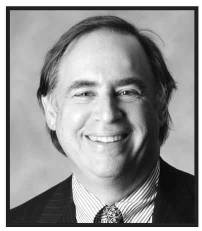

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In the wake of the current credit crisis and continuing decline in the United States economy, Congress and the Obama administration are expected to introduce sweeping new reforms that will increase governmental oversight of the financial services market. Through reporting requirements and other tactics, these reforms will seek to correct the failed policies of the recent *laissez faire* regulation of financial institutions and their products and participants.

To ensure the long-term viability of the United States financial system, any reforms must seek a balance between the reduction of systemic risks to the financial system and preservation of the freedom of the nation's economy to grow and successfully participate in the global economy.

This article presents a brief history of governmental regulation of the banking and securities industries, the findings and recommendations of a recent Congressional Oversight Panel's report on the current state of the financial system that likely will form the base for a reform package and some additional thoughts about what Congress should consider in its reform package.

History Of Banking Law In America

Amid the Great Depression, following the stock market crash of 1929, Congress passed the Banking Act of 1933, commonly referred to as the "Glass-Steagall Act." Glass-Steagall was defining legislation that transformed America's banking and securities industries into the most trusted and stable in the world by prohibiting entities from engaging in both commercial and investment banking. Congress enacted the separation to provide the public with safe commercial banks that could not take substantial risks in the securities markets. Glass-Steagall reflected the need for stability in the banking industry to ensure confidence in the economy, which at the time, outweighed the need to preserve competition in the marketplace.

For the most part, the principles of Glass-Steagall, separating investment and commercial banking, endured until the 1980s. Beginning in 1980, both federal and state governments along with courts (including the U.S. Supreme Court's decision in *Board of Governors of the Federal Reserve System v. Investment Company Institute*, 450 U.S. 46 (1981)), relaxed and removed barriers that constrained bank consolidation and engagement in investment advisory services. Then, in November 1999, Congress passed the Gramm-Leach-Bliley Financial Modernization Act ("GLB Act"), marking the official death of Glass-Steagall. The GLB Act allowed commercial and investment banks to engage in activities formerly prohibited by Glass-Steagall. Congress and the banks touted the GLB Act as beneficial for both consumers and businesses because of the increased product offerings and competition expected to emerge from its implementation.

Fallout From Deregulation And The Emergence Of The "Shadow Financial System"

With the emergence of the information age and their newfound capabilities, financial institutions in the early part of this decade sought to take advantage of the capital intensive nature of certain industries. They started issuing excessive extensions of credit as an incentive for their borrowing customers also to use their advisory and securities underwriting services, a veritable financial supermarket. This resulted in a number of companies incurring large amounts of debt that were not supported by adequate capital or revenue generation. What followed was a brief economic downturn (itself a precursor to the current financial crisis) caused by the likes of WorldCom and Enron. It might have grown worse if the government had not relaxed credit oversight and provided low interest rates to allow the economy to expand. In fact, these measures merely served as a bandage for the financial industry. Collateralized debt obligations (including mortgaged-backed securities) and credit default swaps turned into the financial market participants' new cash cows. Deregulation allowed the emergence of a secondary market for these products with no government oversight: a market appropriately called the "Shadow Financial System."

The Shadow Financial System is characterized by a variety of unregulated financial instruments such as over-the-counter derivatives, credit default swaps, conduits and structured investment vehicles. Demand was high for these products, especially credit default swaps, which by the end of 2007 had reached a market capitalization of $45 trillion. However, the stored value of these products was not supported by "real" capital. Rather, computer models predicting risk and the likeli-

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hood of default as well as the credit ratings of the issuers supported the valuations. As we now know, these computer models proved too optimistic, as waves of economic turmoil finally revealed the market's concealed fragility, bringing us into the current deep recession.

Thus, following enactment the GLB Act, oversight and control over the U.S. financial system decreased to levels not seen since before the Great Depression. As the government deregulated the financial market, participants created more and more sophisticated and complex securities, producing significant revenue streams for them. Investors bought, sold and traded these unregulated products in ever-increasing amounts, stimulating remarkable growth until now. In retrospect, it was only a matter of time before this toxic mixture of reduced oversight, increased products and financial market greed would result in a financial system teetering on the brink of collapse.

Critical Source Of Regulatory Recommendations

In January 2009, a Congressional Oversight Panel (the "Panel") issued its "Special Report on Regulatory Reform" analyzing the current state of financial system regulation and offering recommendations to Congress for future regulation and oversight of the financial system. The Panel's recommendations address directly problems that surfaced following passage of the GLB Act (and repeal of Glass-Steagall), along with other related judicial and legislative actions that reduced the government's oversight of financial market participants.

The Special Report focused on the following significant considerations:

Systemic Risk of Financial Institutions

The Panel found that, in the current regulatory environment, "systemic risk is often not identified or regulated until a crisis is imminent." Systemic risk is the risk of collapse to an entire market or system as opposed to the risk allocated to one component of that system. Currently, there are a number of regulatory authorities which govern the financial markets in the United States. These authorities, including the Securities and Exchange Commission, Treasury Department, Federal Deposit Insurance Corporation ("FDIC"), Federal Reserve Board ("Fed"), Commodity Futures Trading Commission and hundreds of state governmental agencies, all occupy critical roles in regulating and supervising the financial markets, but lack any authority, structure or hierarchy to manage the system as a whole. To alleviate this, the Panel recommended naming one regulatory authority to exercise prudential oversight to ensure that each financial institution meets certain capital and insurance requirements specifically tailored to its size and systemic significance.

Excessive Leverage in Financial Institutions

The Panel noted that financial organizations are holding too many risky financial assets with too little reserve capital. The Fed has always regulated the "asset to capital" ratio of commercial banks; however, with less and less regulatory oversight, commercial banks now hold riskier assets and other financial market participants are acting like banks. The Panel set forth four alternative requirements to regulate all financial institutions: objective-based capital requirements that correspond to an organization's systemic risk; leverage requirements applicable in a consistent manner across all financial institutions; countercyclical capital requirements to help financial institutions properly manage in a downturn; and, liquidity requirements to ensure that these institutions are equipped with assets that are easily identified and liquidated in a downturn.

The Shadow Financial System

The Panel stressed that regulators must have jurisdiction over the entire Shadow Financial System to "enforce common standards of transparency, accountability, and adequate capital reserves."

Making Sense Of The Panel Recommendations And Identifying The Missing Link

As indicated, a number of the Panel's recommendations derive directly from problems that surfaced following the passage of the GLB Act and related judicial and legislative/regulatory actions. In the current economic climate and with continuing pressure from the Fed and others, it is likely Congress will soon enact legislation that closely tracks the Panel's recommendations, bringing sweeping changes to the way financial institutions are regulated. While the Panel has accurately pinpointed most of the problems, wholesale adoption of its recommendations could lead to an overly regulated financial system that does not provide for vibrant economic activity.

In addition, the Panel did not address the direct effects of credit being extended in conjunction with the cross-selling of other investment products and services. When Congress repealed Glass-Steagall, it failed to implement any procedures to limit the increased systemic risk created by these financial supermarkets. That has caused problems which fly in the face of what the original supporters of Glass-Steagall intended – to protect bank customers by ensuring banks did not engage in imprudent lending or sales of high risk securities to their customers. Their predictions in 1932 of corporate malfeasance, self-dealing, and imprudent lending practices seem prescient today.

On the other hand, the emergence of today's financial supermarkets brings a limitless supply of opportunity to create a robust global financial services industry. In the interest of increased competition, Congress repealed Glass-Steagall, allowing commercial banks to achieve anticipated efficiencies and synergies that could come from controlling all aspects of corporate finance. Merely returning to Glass-Steagall would undermine that value.

The missing link in all this is a modern approach to the financial supermarket. We recommend that any new legislation should include the following to tie the Panel's recommendations together with marketplace realities:

1. First, such legislation should increase oversight and transparency of information, including potentially requiring banks to disclose to securities purchasers their commercial lending relationships if they are providing other financial services to the issuer. Such disclosures are like the disclosures that research analysts make regarding their firm's investment banking relationships with the companies on which they issue opinions.

2. Second, such legislation should reduce or eliminate certain conflicts of interest to ensure prudent bank lending. An approach similar to Section 201 of the Sarbanes-Oxley Act, which makes it unlawful for a registered public accounting firm to provide any non-audit service to an issuer contemporaneously with the audit, would reduce conflicts of interest that could arise when a bank is providing both lending and non-lending services to its customers. By reducing or eliminating certain business arrangements between lending banks and their customers, the responsibilities of the lender to perform proper credit analysis will again move to the forefront rather than allowing lending practices to take a back seat to other non-lending activities. Enacting these kinds of safeguards has ensured more reliable financial audits and will similarly restore accountability (and perhaps trust) to commercial lending practices.

Conclusion

Before the passage of Glass-Steagall, the United States economy faced a systemic financial crisis every 10 to 20 years. After the passage of Glass-Steagall, there were no systemic financial crises until now . . . 10 years after the repeal of Glass-Steagall. However, structural changes to the backbone of the United States economy still suggest that the passage of the GLB Act was timely and it continues to provide important economic benefits. The limitations that Glass-Steagall placed on free enterprise were overly restrictive and reduced growth potential now embedded in the financial supermarkets. In today's world, any new legislation should embody the spirit of Glass-Steagall, while maintaining the benefits of the GLB Act. The phoenix may rise again, just not as high.

Authors' note: The article's analysis of the Glass-Steagall Act is based in part on the law review comment originally authored by Mr. Rosenfeld in 2003. Mr. Rosenfeld would be pleased to address any questions you may have.