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Capital Structure During Financial Crises

The Capital Markets Crash of 2008: What Kind of Regulatory Reforms Are Needed?

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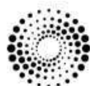
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HANK BOERNER

THE CAPITAL MARKETS CRASH OF 2008: WHAT KIND OF REGULATORY REFORMS ARE NEEDED?

The kind of corporate governance failures that we are seeing in the collapse of leading investment banks, commercial banks, and other financial services powerhouses was not supposed to happen any more. Where were the boards of directors when Countrywide, Lehman Brothers, Bear Stearns, Washington Mutual and others were driven over the cliff by their managers? An oh-so-logical question we could ask: What were the top executives of these firms thinking?

The sweep of the comprehensive reforms of the Sarbanes-Oxley (SOX) package of federal statutes and regulatory measures were supposed to address accounting and financial disclosure shortcomings, and various regulatory abuses that had built over time. The widespread use of accounting shenanigans—such as the extreme overuse of off-balance sheet "special purpose entities" (SPEs)—was supposed to be very limited in the post-Enron era. SOX seemed to assume there would be no more Raptor-emblazoned SPEs to hold liabilities out of investors' sight.

Corporate governance failures

But apparently it was not to be. In fact, in the SOX era, off-balance-sheet slight of hand stashed tens of billions of dollars from leading banks and investment banking firms. Could it be that now we are seeing a post-Enron style of "hide — the — liabi financial engineering on a scale never seen before? The world's capital markets are going through convulsions to an extent not seen in decades. After all the dust of the present financial crisis subsides, we may find that these Enron-type accounting practices put an unbelievable number of financial services organizations at risk, with some like Bear Stearns and Lehman Bros totally failing in the process.

Where there once were five major investment banks ruling Wall Street, today there are... none! The two survivors have become nationally chartered banks.

Weren't the reforms of the early twenty-first century supposed to prevent these types of events from happening? SOX was a package of eleven separate measures, the majority of which updated the federal 1933 and 1934 "New Deal" securities legislation. (The Securities Act and the Security Exchange Act, respectively. The Securities Exchange Act regulated stock exchanges; investment transparency and disclosure; self-regulating organizations (SROs); and the actions of brokers, intermediaries, and corporate issuers.

Another important piece of legislation was put into place in 1940—the Investment Company Act—to govern the activities of mutual funds and their managers. (The first mutual fund was created in 1928, just before the Great Crash. Mutual funds' wildly popular predecessor was the "investment trust," some of which grew large; all 550+ of these tanked along with their investors' dollars in October 1929.)

Over the decades since the 1930s, there have been periodic updates and expan-

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sions of the New Deal era laws. The first act of President Franklin Roosevelt upon assuming office in March 1933 was to declare a national "bank holiday," shutting down all US banks so their books could be reviewed and their solvency determined. Many banks never reopened. There followed a full slate of federal "banking reforms," including clear separation of banking and brokerage operations. Thus,"Morgan Stanley" emerged from the Morgan Bank.

It is reported by historians that the sweep of the legislation deemed necessary by the Congress and President Roosevelt was so all-encompassing that it took two sessions for Congress to hold hearings, grill witnesses, analyze and digest the facts, and then process and pass the laws. (Congress met for just part of the year back then.) By the end of the 1930s, the United States had a powerful framework in place to try to prevent the kind of financial chaos that occurred in October 1929 and the awful aftermath, including the years of the Great Depression.

One of the most important reforms enacted to protect consumers in the New Deal era was the Glass-Steagall Act. This Act separated banking and brokerage operations, created federal deposit insurance for bank accounts, regulated bank holding operations, and proscribed many banking activities.

A look back at 1999 reforms

As the twentieth century was ending, the US Congress decided that the regulatory framework in place to govern banking and the securities industry should be "reformed." Congress passed the Gramm-Leach-Bliley Act, which in a sweep of President Bill Clinton's pen overturned seven decades of federal regulatory philosophy and set the stage for the emergence of US financial services "supermarkets."

Large money center banks — such as Citibank of New York and Bank of America—began acquiring, merging with, and consolidating a range of banking and nonbanking operations as "financial services" giants. Some proponents argued that the reforms enabled US banks to compete more effectively in the global marketplace.

President Bill Clinton and the congressional leaders said at the time that the new regulations would serve consumers better: "The world changes, and Congress and the laws have to change with it," said former Senate Banking Committee Chairman Phil Gramm. Gramm said the bill "would improve banking competition and stability."

"This is a bill that is bipartisan, bicameral, and tri-institutional," said Representative Jim Leach, chairman of the House Banking and Financial Services Committee. President Clinton said the measure would "save consumers billions of dollars a year through enhanced competition." The president said the new approach would protect consumers' rights and require banks to expand the availability of funds for community development.

At stake was an estimated $350 billion that Americans spend annually on fees and commissions for banking, brokerage, and insurance services. Supporters of the bill believed it would save consumers some $15 billion each year due to greater choice and competition. Consumer groups and other opponents feared that Gramm-Leach-Bliley would heighten prices and jeopardize consumers' financial privacy.[1]

BEFORE THERE WAS FEDERAL BANKING AND SECURITIES PROTECTION LEGISLATION IN PLACE, ONE BY ONE THE STATES HAD ADOPTED SECURITIES AND BANKING REGULATIONS.

State level protections

Before there was federal banking and securities protection legislation in place, one by one the states had adopted securities and banking regulations. Before the 1929 crash, New York State had put into place investor protections under the "Martin Act." President Franklin Roosevelt, who served two terms as New York's governor, brought important pieces of his state's legislation to Washington as elements of the New Deal reforms. And seven decades later, New York Attorney General Eliot Spitzer would wield a big club — the same Martin Act—against the biggest brokerages and investment bankers on Wall Street.

And in 2008 his successor, Attorney General Andrew Cuomo would again wield

THE RATIO OF PAID LOBBYISTS TO FEDERAL LEGISLATORS IN WASHINGTON, DC IS NOW ESTIMATED AS BEING 100 TO 1.

the Martin Act over the heads of financial services corporations on a number of fronts, including attempts to "claw back" certain payments to financial services industry executives receiving public assistance.

Questions hanging in the air in 2009

As we dissect the 2007-2008 capital markets crisis, a number of questions will be posed by those government officials who take on future market reforms. That includes members of Congress, the president and certain of his cabinet officers, commissioners of regulatory bodies such as the Securities and Exchange Commission, and leaders of congressional-sponsored bodies such as the Financial Accounting Standards Boards, and the Financial Industry Regulatory Authority, which replaced exchange-level SROs.

- Did the removal of the seven decades of public policy regarding separation of depository banking institutions and securities and investment banking organizations lead to the weakening and reduction of effective risk management (by the combined financial services "supermarkets" or stand-alone traditional banks)?
- Did a "cozy" relationship—too cozy, some experts say—develop among the banks and brokers in the combined operations?
- Did the emergence of financial services supermarkets blur some of the traditional roles of bankers? For example, for decades most banks kept mortgages and other loans in their portfolios; the compounding away of borrower payments to the bank built bigger and more sustainable banking enterprises. After the 1999 reforms, banks began moving large volumes of their loan portfolios to the Wall Street "securitizers" who peddled the investment-grade packages to investors, such as state pension funds, money market funds, mutual funds, and other institutions.
- Did this practice encourage bankers to relax their usual credit and portfolio risk management policies and to give too many less-than-credit-worthy borrower loans? (If the loan is not in the bank's long-term portfolio but "somewhere out there" as securitized collateral, it is technically off the bank's books, right? And therefore, less loan reserves are needed for default . . . right?)

Other issues to address

These questions will be for starters as the US Congress gets down to work in 2009. (The 111th Congress was elected in November 2008 and will serve two years.) Thanks to a sea of multinational paper agreements signed by the United States over the years, not every element of the regulations that will be proposed will be a domestic issue. The reforms of the New Deal era, which addressed the US domestic policy agenda, were followed (starting a decade later) by such measures as the Bretton Woods agreements for global monetary policy, and much later by the Basel agreement governing global banking rules. These will be factored into congressional dialogues on reform.

The ratio of paid lobbyists to federal legislators in Washington, DC is now estimated as being 100 to 1 (in addition to a virtual army of unpaid volunteers set on lobbying lawmakers on various causes). Washington, DC could resemble the familiar scene of medieval fair days when all those with an agenda for financial services and banking reforms descend on the capital city!

Questions in the air about needed reforms will probably also include the following:

- What terms and conditions could be applied to the $1.5 billion-and-counting federal bailout of banks and other financial organizations? (Very few strings, apparently, were attached by the Treasury Department to the rescue package.)
- How should the federal government oversee what is now a seminationalized banking industry? (Financed, after all, with taxpayer money.)
- What is the appropriate infrastructure to be put in place for American

banks to assure their long-term viability? (We don't want to stifle innovation and interrupt the delivery of banking services for sections of the US population; we will want to reexert effective risk management policies, etc.)
- What should be done for those recent innovations—*the exotica*—ginned up by Wall Street in recent years? (These include hedge funds, dark pools, credit swaps, and all kinds of *unregulated* and opaque derivatives.)
- How do you regulate and/or address risk in derivatives if the asset (assuming it is real and solid) is leveraged through derivative instruments of various kinds to levels of 20-to-l, or even 30-to-l, as was regularly done by a number of investment banking houses? (What is the real value of the underlying asset and all extensions thereof?)
- What should be done about regulating credit risk agencies (such as S&P and Moody's) that slapped "triple-A rated" on mortgage-backed securities obligations with no peek inside the package? (Those packaged debt obligations, some of which will not be paid, are the ticking time bombs in the global capital markets. What will the regulators do to reform the credit risk agency environment going forward?)

Surely, there will be federal government attempts to reign in executive compensation. (Representative Barney Frank has had a bill pending to give shareowners a voice in appropriate executive compensation—this is just the beginning of the measures we will see.) The American citizenry—the great majority of which is not made up of highly paid corporate executives—is demanding reforms in CEO and executive incentivizing. Count on a legion of institutional investors also to address the issue, directly with corporate management and through proxy campaigns if dialogue fails to lead to progress in meeting the demands of investors.

There are going to be numerous public policy issues on the table. Should the US accelerate the harmonization of US and global accounting rules (IFRS)? Would that reduce financial and accounting gamesmanship in corporate America?

What kind of transparency rules should be put in place to show the true condition of an investment? (This helps to advance the argument that the rest of the world's "principal-based accounting" will make boards and executives more *accountable* to their owners in the future.)

Finally, judging from the commentary of experts already weighing in on future reforms, is a total overhaul of the regulatory framework for financial-related activities in order? Should a recombination of regulations of some kind be adopted to address the changes that the US government encouraged back in 1999 when the walls between banking and other financial services came tumbling down? This list is just the beginning: A great deal is at stake in the coming public policy debates. •

NOTE

[1] "Clinton signs banking overhaul measure," CNN.com (November 12, 1999).