Please feel free to contact us if we can provide further information on these matters.

B. Robbins Kiessling
212-474-1500
bkiessling@cravath.com

Erik R. Tavzel
212-474-1796
etavzel@cravath.com

(Re)regulation of Financial Services—Back to the Future?

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As the financial crisis has deepened over the past year, first the Bush Administration and now the Obama Administration have announced ambitious plans for comprehensive reform of the financial regulatory system. Not to be left behind, at the same time current and former members of Congress and Government officials, international groups such the G-20 and even the mainstream press are weighing in on the need for reform and the shape it should take. Although the immensely complex process of actual reform has barely begun, the key players have said enough to allow a good guess as to their goals for the post-regulatory reform financial world. There will be an intense focus on regulating and reigning in "systemically important" financial institutions. Institutions will face tighter regulation of risky activities and stricter capital and funding requirements. The regulatory net will be cast much wider, capturing institutions and activities previously not subject to substantial regulatory oversight (most notably, purveyors of derivatives and credit default swaps such as AIG's Financial Products division as well as certain private investment funds). What will these changes mean for today's financial institutions? How will reform change the shape of the industry in the coming years?

Turning to the history books may, in fact, provide useful insights. One popular point of view is that the post-reform financial industry should look more like it did in the 50 years from the mid-1930's to the mid-1980's before the consolidation and deregulation of the past two decades. Whereas in the mid-1980's the only financial institutions that even theoretically could pose systemic risk were a handful of highly-regulated money center banks whose business was largely limited to taking deposits and making loans to large corporations and foreign governments, over the past 12 months we have learned that a much broader array of institutions with extensive unregulated or lightly regulated businesses can be "too big to fail." However, while looking back at history is informative and certain of the deregulatory changes of the last two decades may in hindsight seem like mistakes, simply turning back the clock is impossible and undesirable. The reform effort will face many difficult questions in figuring out how to restructure the system based on today's financial market and macroeconomic realities. This bulletin looks ahead to some expected features of regulatory reform and associated questions and challenges.

"We really need to simply end too big to fail. . . . We need to reduce systemic risk by limiting the size, complexity, and concentration of our financial institutions. . . . We need to create regulatory and economic disincentives aimed at limiting the size and number of systemically important financial firms."
—Remarks of FDIC Chairman Sheila C. Bair to the American Bankers Association Government Relations Summit, Washington, DC, on April 1, 2009

SIZE OF INSTITUTIONS

Treasury Secretary Timothy Geithner and others have stated that one of the goals of regulatory reform should be to avoid institutions that are "too big to fail." The trend in the financial services industry in the past few decades, however, has been precisely the opposite. Since the early 1980's, we have witnessed massive consolidation, fueled by the lifting of the prohibition on interstate banking, the repeal of the Glass-Steagall Act, the S&L and regional bank crises, globalization and technological advances. Today, the combined assets of the four largest U.S. commercial banks – JPMorgan Chase, Citigroup, Bank of America and Wells Fargo – represent 64% of the total assets of all U.S. commercial banks. Many firms that were once prominent, well-known names have been absorbed by other institutions, even before the financial crisis led to further consolidation. On the banking side, for example, today's JPMorgan Chase includes among its predecessors Chemical Bank, Manufacturers Hanover, Chase Manhattan, J.P. Morgan & Co., First Chicago, Texas Commerce and Bank One (itself the product of numerous mergers). The current Bank of America's predecessors include NationsBank, NCNB, First National Bank of Boston, Security Pacific, Continental Illinois, LaSalle Bank, Fleet, Norstar, Maryland National Bank and the old Bank of America. On the investment banking side, Citigroup acquired Salomon Brothers and Smith Barney. Credit Suisse acquired First Boston and DLJ. Morgan Stanley merged with Dean Witter.

"Investors and creditors have lacked strong incentives to perform due diligence because of the perception that these institutions are so large and complex that the government would have to bail them out. And they were absolutely right."
—Remarks of FDIC Chairman Sheila C. Bair to The Economic Club of New York, on April 27, 2009

Despite the concern over systemic risk, this trend toward consolidation has been accelerated by the financial crisis, as weaker firms have been absorbed (either voluntarily or involuntarily) by better-capitalized rivals. For example, Bank of America acquired Merrill Lynch, JPMorgan acquired Bear Stearns and Washington Mutual, and Wells Fargo acquired Wachovia.

Against this background, the objective of limiting the size of institutions raises important questions and faces significant challenges. As a threshold mater, what will be the framework for achieving this goal? Will there be new rules simply limiting size based on certain clearly identifiable metrics (such as assets or deposits)? Will there be objective criteria at all or a "you know it when you see it" approach? How will financial institutions and their regulators deal with the fact that systemic importance is at least in part a function of the identity and importance of your counterparties? Will institutions be subject to an after-the-fact determination that could have a significant impact on their activities? And what will be the consequences of being systemically important? Will it be more stringent capital requirements, as suggested by Secretary Geithner, or limitations on certain risky activities, as suggested by Paul Volcker and others, or will divestitures be required? And, if divestitures are required, how will the downsizing of firms that are currently "too big to fail" be accomplished? Will some of the crisis-related combinations encouraged by the government in the past year have to be undone? Putting aside systemic importance, are we entering an era where scale will be discouraged? How can institutions simultaneously be big enough to compete globally but not be too big to fail? The answers to these questions not only will impact the new rules, but will influence every aspect of the business and strategy of large financial institutions—including decisions on lines of business, M&A activity, capital structure, risk management and personnel.

"Is the future to go back and reconnect some portion of Glass-Steagall? Some say that can't be done; others say it must be done. But that decision has to be made, and I don't think it's old fashioned to go back to protections that previously existed."
—Senator Byron Dorgan when being interviewed by Maria Bartiromo for *BusinessWeek*, March 12, 2009

ACTIVITIES

Just as the trend over the past few decades has been one of consolidation of entities, there has also been a trend to combine formerly separate activities (*e.g.*, commercial banking, securities underwriting and brokerage, proprietary trading and derivatives) under the same umbrella, a trend that was accelerated by deregulation, culminating with the repeal of Glass-Steagall in 1999. This trend was also driven by globalization, technological innovation and the development of new financial products, all of which created linkages between markets and products.

Because of the belief that engaging in certain high-risk businesses led to the failure – or near-failure – of some large institutions, regulatory reform casts at least some doubt on the continuation of this trend. At one extreme are calls to reenact Glass-Steagall and return commercial banks to their traditional functions. Of course, this approach would not in any way address the risks posed by non-bank institutions – the future AIGs, Bear Stearns or Lehmans. Furthermore, many of the businesses that got commercial banks into trouble, such as sub-prime mortgages, were not prohibited by Glass-Steagall anyway. While it is true that the fall-out from the crisis ultimately may create opportunities for smaller and new financial firms that can take big risks without creating systemic issues (but keep in mind Long Term Capital), simply prohibiting large institutions from engaging in specified risky but otherwise important activities (such as structured finance) seems impractical and unlikely to speed the return of robust private capital markets and economic growth. And despite the apparent nostalgia for the old private partnership model of Goldman Sachs and Morgan Stanley, it is unrealistic to expect small private firms to deploy the scale of capital required today. A more feasible approach would be to discourage the scale of certain activities by imposing direct limits on their absolute or relative size within significant, if not necessarily systemically important, financial institutions. Another option would be to impose higher capital charges on certain businesses, an approach which is already used, for example, to limit merchant banking investments by financial holding companies.

"The events of the last year have put into stark relief the tension between innovation and stability. But, if we abandon, as opposed to regulate, market mechanisms created decades ago, like securitization and credit default swaps, we may end up constraining access to capital and the efficient hedging and distribution of risk, when we ultimately do come through this crisis."
—Speech of Goldman Sachs CEO Lloyd Blankfein to the Council of Institutional Investors on April 7, 2009

Better risk management could be another approach to high risk activities. A number of the serious failures during the crisis were caused by poor risk management (not to mention regulatory changes that gave institutions more discretion in managing risk). One possible approach would be to implement requirements which ensure that the risk management function has appropriate prominence and autonomy and that senior executives of financial institutions and their boards have access to the complete picture across all business lines and geographies to better assess exposures and avoid underpricing risk. Better risk management also depends in part on more consistent and reliable accounting standards, another focus of the reform effort.

Of course, even if the U.S. retreats from the large, broadly-diversified financial institution model, it is not clear, despite the statements by international leaders such as the G-20, that regulators around the world will follow suit. In fact, the pressure of competition from large and more integrated European and Japanese banks contributed to the consolidation of the U.S. banking industry. The big U.S. banks may correctly argue that they need to retain their current business model in order to remain competitive globally. If regulation is not uniform internationally, will reregulation in the U.S. and other countries just cause innovation and activities to migrate to less-regulated jurisdictions?

"Capital requirements for [systemically important firms] . . . must be less pro-cyclical, requiring firms to build up substantial capital buffers in good economic times so that they can avoid deleveraging in cyclical downturns."
—Written testimony of Treasury Secretary Timothy Geithner before the House Financial Services Committee on March 26, 2009

CAPITAL, FUNDING AND LIQUIDITY

As the crisis deepened last year, many of the world's leading financial institutions found themselves with insufficient capital to absorb losses, let alone continue lending. Under Treasury's proposal, capital requirements for systemically important firms will be more rigorous than for other firms. However, more capital for big firms is only part of the story. Domestic and international regulators seem interested in a more dynamic model which would require financial institutions to build up extra capital buffers in good times in order to avoid rapid deleveraging during downturns. In addition, there is a belief in some camps that the trend of giving financial institutions themselves substantial discretion with regard to capital has failed. As a result, there has been renewed focus on simple leverage ratios as a means to achieve more consistent application across institutions and jurisdictions. Of course, we also expect new capital requirements for previously unregulated or lightly regulated nonbank financial institutions. What will be the impact of all this on balance sheets and the economy in general? Taken together, all of these changes point to more capital and smaller balance sheets, which could mean less credit in the system and perhaps less profitable financial institutions in the hope of mitigating the boom and bust cycle. On the other hand, because capital is expensive and size may be discouraged, financial institutions will seek to focus even more so than before on the most profitable activities and assets, which often involve more risk. The reform effort will need to walk a fine line—the financial system needs safe and sound institutions that can survive downturns while at the same time providing sufficient, reasonably priced credit necessary for robust economic growth.

"Strengthened regulation and supervision must . . . reduce reliance on inappropriately risky sources of financing; and discourage excessive risk-taking."
—G-20 London Summit Leaders' Statement of April 2, 2009

In addition to more conservative capital requirements, the ways in which financial institutions finance their businesses in the future may also become more conservative. The collapse of Bear Stearns and Lehman Brothers exposed the risks inherent in over-reliance on wholesale funding, especially when used to finance long-term assets. Even relatively healthy firms were adversely affected by the liquidity crisis. Reform proposals have included statements about the need to reduce reliance on excessively risky sources of funding and to impose "more demanding liquidity constraints" for systemically important firms. However, despite an apparent consensus that the old wholesale funding model is too risky, there has been very little discussion about the types of funding arrangements or restrictions that will take its place. Perhaps systemically important institutions will be required to adhere to minimum weighted average life metrics on their outstanding debt, or will be subject to higher capital charges for significant reliance on certain sources of funding. Apart from regulatory changes, the need for stable financing has increased the relative attractiveness of deposits as a source of funding. However, it should be kept in mind that a strategy of rolling up regional banks to create a funding base could run counter to the regulators' interest in reducing systemic risk.

"Financial institutions and markets that are critical to the functioning of the financial system and that could pose serious risks to the stability of the financial system need to be subject to strong oversight by the government . . . . Financial products and institutions should be regulated for the economic function they provide and the risks they present, not the legal form they take."
—Written testimony of Treasury Secretary Timothy Geithner before the House Financial Services Committee on March 26, 2009

A WIDER REGULATORY NET

The financial crisis has made clear that it is not just failing banks that threaten the stability of the financial system. Nonbank financial institutions such as AIG and Bear Stearns, private hedge funds and possibly even private equity funds can be "systemically important." The effort to regulate nonbank financial institutions and private investment funds above certain size or leverage thresholds according to the same standards as systemically important banks will raise many unanswered questions. What activities will be regulated, how and by whom? Will nonbank financial institutions be subject to the same rigorous capital regime as banks? Will the scope of regulation be focused only on systemically important institutions? Does that run the risk of the regulators having a role only after the institution is already too big to fail and problems being discovered too late? Also, regulatory tools from the bank context will not necessarily work elsewhere. For example, Treasury's proposed resolution authority for systemically significant financial companies was modeled closely on the FDIC's powers to seize failing banks under the Federal Deposit Insurance Act, but would apply to much more complex and geographically dispersed organizations. Resolution of these financial companies would require more difficult decisions and discretionary judgments than those typically made by the FDIC in a bank seizure, where the objective is clear—protect insured depositors at the least cost to the insurance fund. Also, despite FDIC Chairman Sheila Bair's recent recommendation that the FDIC itself should exercise that resolution authority, the FDIC has only limited experience seizing systemically significant banks and no experience seizing systemically significant nonbank financial companies.

CONCLUSIONS

Regulatory reform is coming. While turning back the clock to the era before consolidation and deregulation may have its fans, returning to the system we had before the innovation, technological change and globalization of the past 25 years simply will not work today, let alone years from now when the memories of this crisis have faded. The key features of the proposed outline for reform — less systemic risk, better pricing and management of risk, more stable capital and funding and less regulatory arbitrage — are good objectives. Success or failure will depend upon getting from here to there in a manner which maintains our dynamic and innovative financial system as a key driver of economic activity and growth.

NEW YORK
Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
212.474.1000

LONDON
CityPoint
One Ropemaker Street
London EC2Y 9HR
+44.20.7453.1000

www.cravath.com