From Glass-Steagall to Too Big to Fail

William Mutterperl, Reed Smith LLP

It took Congress only a handful of pages in 1933 to protect the financial system from future meltdowns such as occurred in the Great Depression. The Glass-Steagall Act was really pretty simple: it set up a legislatively mandated wall between commercial banking and investment banking. It is generally credited as having protected the financial system well for about 60 years; although commercial bankers particularly complained as the years rolled while investment bankers created new deposit-like products and commercial paper replaced many bank lines, all of which tended to unlevel the playing field in favor of the investment bankers. The wall between investment banking and commercial banking began to break down through regulatory action, primarily by the Federal Reserve, in the 1980's, and was finally torn down once and for all with the passage of Gramm-Leach-Bliley in 1999.

In the wake of the near meltdown of 2008, with taxpayers to one degree or another bailing out numerous financial institutions such as Bear Stearns, Washington Mutual, and American International Group (AIG) to name a few (but not Lehman Brothers), the legislative response took 2,300 pages in the form of the Dodd-Frank Act, which merely laid out a template to be followed by probably tens of thousands of as yet unwritten pages of implementing regulations by numerous agencies over the next few years. While some argued for the restoration of Glass-Steagall, Congress opted for a different approach, at the heart of which was the intended elimination of the doctrine of "too big to fail" (TBTF), in the name of which institutions deemed systemically important were rescued at tax-payer expense.

Of course TBTF is an ethereal concept to begin with; and attempting to "outlaw" it was quite challenging. And so Dodd-Frank seeks to accomplish this goal through a variety of approaches contained within a number of its 16 titles. Instead of drawing one big line in the sand, a la Glass-Steagall, Dodd-Frank elevates regulatory oversight to unprecedented levels as the preferred method of preventing the next meltdown. As to whether this approach will be successful, I think it is safe to say that the "jury is still out" and will be for many years to come.

At the very heart of the legislation, of course, is the establishment of the interagency Financial Stability Oversight Council (Council) created by Title I of Dodd-Frank. This 15-member group, consisting primarily of senior financial regulators of different agencies and chaired by the Secretary of the U.S. Department of the Treasury (Treasury) has the daunting task of identifying financial companies whose failure could pose a systemic risk to the system and then subjecting them to drastically heightened standards of prudential regulation, to be overseen for the most part by the Board of Governors of the Federal Reserve System (FRB), to prevent any institution from becoming TBTF or acting in a way which could create systemic risk. It places an enormous responsibility on many of the same agencies which failed to recognize, or to act in the face of, the housing bubble, combined with

© 2011 Bloomberg Finance L.P. All rights reserved. Originally published by Bloomberg Finance L.P. in the Vol. 4, No. 1 edition of the Bloomberg Law Reports—Banking & Finance. Reprinted with permission. Bloomberg Law Reports® is a registered trademark and service mark of Bloomberg Finance L.P.

The discussions set forth in this report are for informational purposes only. They do not take into account the qualifications, exceptions and other considerations that may be relevant to particular situations. These discussions should not be construed as legal advice, which has to be addressed to particular facts and circumstances involved in any given situation. Any tax information contained in this report is not intended to be used, and cannot be used, for purposes of avoiding penalties imposed under the United States Internal Revenue Code. The opinions expressed are those of the author. Bloomberg Finance L.P. and its affiliated entities do not take responsibility for the content contained in this report and do not make any representation or warranty as to its completeness or accuracy.

complex financial engineering, which most observers seem to believe was the focal point of the 2008 disaster. The hope seems to be that putting this group in one room and making them act in concert will give them the prescience to foretell the next activities and players that present a potential systemic risk; while simultaneously endowing this group with a powerful tool kit to take remedial action to head off the catastrophe.

In addition to relying on this unified group to identify the risks that they each failed to identify independently, Dodd-Frank assumes that the Council will also have the political will to utilize their unprecedented tool kit to break up companies it deems TBTF or to prevent activities which pose a systemic risk. The task is all the more daunting because the various agencies don't necessarily share the same agenda (*e.g.*, we have seen how the Securities and Exchange Commission's staunch adherence to uniform accounting policies has conflicted with the banking regulators' desire to maintain robust reserves at all times). And so the effectiveness of the Council, which is the lynch pin of Dodd-Frank, will probably not be known for many years. Currently, however, not much has changed. There clearly is more risk aversion in the industry, which is both self-imposed and imposed by the regulators; but the structure of the industry remains the same. If there were institutions that were TBTF in the past, there are even bigger ones which have evolved through the consolidations necessitated by the crisis of 2008.

Rather than relying solely on the Council's willingness to take apart institutions deemed TBTF, the legislation seems to rely on an approach which penalizes these institutions by imposing a plethora of heightened prudential standards (*i.e.*, leverage limits, concentration limits, heightened capital requirements, enhanced public disclosure, so-called "living wills"—and the list continues) applicable to this group, which may make them less competitive and cause them to shrink their business models voluntarily, without the need for the Council or FRB to order politically painful fiats in the form of divestitures.

The first big test of the will and wisdom of the Council will be its determination of the institutions that will be singled out for special treatment. In the case of bank holding companies, the answer is pretty simple—an institution by default will be considered systemically important (SIFI) if it has over $50 billion in assets. But for non-bank financial institutions (companies with at least 85 percent of income or assets related to financial activities) the determination will be made by a 2/3rd super-majority of the Council, including the affirmative vote of the Secretary of the Treasury, pursuant to its evaluation of a company's profile based on a list of both generalized and subjective legislative factors. (It is interesting to note that a process which should be as apolitical as possible gives a veto right to a member of the President's Cabinet.) Just as investment banks avoided becoming bank holding companies until the crisis got so bad they had little choice but to submit themselves to FRB regulation so they could benefit from greater access to FRB's resources, one can envision large non-bank financial institutions fighting to avoid SIFI designation (and therefore FRB prudential oversight) at all costs. In fact, in response to some initial proposed rule-making on this subject by the Council, whole industry groups have already submitted comments as to why they should not be deemed SIFIs.

One could easily write a tome exclusively about Title I (which itself runs some 189 pages) but that is beyond the scope of this article. The point is that Congress has invested enormous authority in the Council in the hope that it will identify and head-off the next crisis before it happens, either through a regimen where financial institutions discipline themselves to avoid becoming TBTF, or in the absence of this self-imposed discipline, then a regimen imposed by the Council and the regulators.

But other, albeit less significant, provisions in Dodd-Frank are designed to prevent TBTF. Title II establishes resolution procedures within the Federal Deposit Insurance Corporation for non-bank financial institutions modeled after its authority to liquidate banks. It is only to be used in limited

© 2011 Bloomberg Finance L.P. All rights reserved. Originally published by Bloomberg Finance L.P. in the Vol. 4, No. 1 edition of the Bloomberg Law Reports—Banking & Finance. Reprinted with permission. Bloomberg Law Reports® is a registered trademark and service mark of Bloomberg Finance L.P.

circumstances involving non-bank financial institutions, the failure of which could create systemic risk and upon super-majority vote by the Council, including the Secretary of the Treasury in consultation with the President. Title II's resolution procedure is designed to prevent the messy collateral damages of a normal bankruptcy proceeding, as occurred in the case of Lehman Brothers, which does not work well in the context of numerous intertwined financial transactions among many institutions. But the creation of a proceeding to wind up non-bank financial institutions in a way that minimizes collateral damage (to the extent that it is possible to do so) does not, alone, prevent the creation of institutions which are truly TBTF. Consequently, Title I remains the focal point for solving the problem.

Other titles of Dodd-Frank, however, are also replete with myriad safety-and-soundness-type provisions applicable to banks, and in some cases non-bank SIFI's, in areas such as derivatives, securitizations, governance, and capitalization, which could play an important role in the process of preventing the creation of institutions considered TBTF. One particular "line in the sand" which has received much attention is the so-called "Volcker Rule." This rule prohibits, with certain exceptions, bank institutions from engaging in proprietary trading, and limits their ability to invest in hedge funds and private equity. Non-bank SIFI's, while not being subject to these specific prohibitions, can still be the subject of increased oversight if they engage in these activities. While most observers do not attribute these activities to the crisis of 2008, these limitations may deter an institution from becoming TBTF by requiring limits to their business models. Already several high profile organizations have announced that they are putting their proprietary trading activities on the selling block now, even though the Volcker Rule provides some very liberal transition periods.

In some cases, the powers of the regulators have been trimmed in a way to prevent bailouts through extraordinary lending or guarantees of obligations of individual troubled institutions. Only broad-based programs available to the industry in general are allowed, and, in some cases, may be provided exclusively to healthy institutions. So if an institution TBTF gets into trouble, the regulators' hands could be tied unless, of course, Congress were to decide that the systemic risk was too great and acted to amend the legislation.

The central point of this article is that by attempting to avoid adopting too many inflexible rules to end TBTF, Congress has instead left it largely in the hands of the regulators to develop and impose the necessary discipline on the bankers, if the bankers fail to do so themselves. The tool kit given to the Council is powerful. The question is whether this Council of diverse regulators will have the wisdom to identify the next problem in advance, and the necessary will to use their enhanced powers to prevent the crisis.

Bill Mutterperl is a partner and member of Reed Smith LLP's Financial Industry Group; he is resident in the firm's New York City office. Bill is the former vice chairman of The PNC Financial Services Group, and prior to that he was general counsel of FleetBoston Financial Corporation. Bill can be reached at 212-549-0263 and by email: wmutterperl@reedsmith.com

© 2011 Bloomberg Finance L.P. All rights reserved. Originally published by Bloomberg Finance L.P. in the Vol. 4, No. 1 edition of the Bloomberg Law Reports—Banking & Finance. Reprinted with permission. Bloomberg Law Reports® is a registered trademark and service mark of Bloomberg Finance L.P.