Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Are Things a Puzzle? Read History*

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September, 2012

It is believed by many that historical events are only existentially relevant for most people if they have occurred during their lifetime, that of their parents, or perhaps that of their grandparents. While that can be argued (in the age of 10 second commercials and communication by 140 characters, it is doubtful that anything that happened 40 years ago is relevant to the current under 35 population), whatever wisdom it includes may help to explain why current policymakers are having such trouble in trying to understand what to do with the banking industry. It might help if they expanded their view sufficient to appreciate what has happened in that industry over a slightly longer period.

For the changes that have occurred over that longer period have been dramatic. Take a simple feature such as number of banks. For over half a century, from the establishment of the FDIC through 1988, the number of FDIC insured banks fluctuated in a very narrow band between about 13,000 and 14,500. When asked how many banks there were in the U.S., industry observers reflexively said — around 13,000 to 14,000.

During the next two decades, however, the number of such institutions fell steadily from that 13,000 level to slightly more than 6,200. In other words, in around 23 years, the industry consolidation reduced by more than half the number of banks in the country, even though for the previous 54 years there had been basically no change.[1]

The largest banks in 1960 were Bank of America, Chase Manhattan, First National City of New York, Chemical, Morgan Guaranty Trust, Manufacturer's Hanover, Bank of California, Security Pacific National, Banker's Trust, and First National of Chicago, and they held 23 percent of the bank

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[1]The number of banking offices, however, grew consistently from about 14,000 when the FDIC came into existence to about 60,000 in 1988. That graph is almost a straight line upwards. There now are around 90,000 offices.

held assets. Today, it is hard to see those 10 banks in the current list of the 10 largest, but most of them (but not all) were acquired by one of the current 10 largest — JPMorgan Chase, Bank of America, Citigroup, Wells Fargo, Goldman Sachs, MetLife, Morgan Stanley, U.S. Bancorp, Bank of New York Mellon and HSBC North America, and they hold nearly 80 percent of the total banking assets.

Banks have continued to fail, but there are great stretches of time when very few, if any, banks failed. For example, from 1943 to 1983 — for 40 years — bank failures effectively didn't happen. At most, there might have been 3 or 4 a year. There is a case study of the stability that many now seek. Yet, when the FDIC's new headquarters building was dedicated in 1963, Chairman Wright Patman, in his dedicatory speech, strongly criticized the leadership of the Corporation for the lack of bank failures! And in the early 1970s, Chairman Fernand St Germain criticized the Corporation because in the previous two or three years 19 banks (!) had failed or been assisted. He and his staff treated it as a major epidemic of failures.

Not exactly in response to that, but nevertheless within a few years after the St Germain hearing, banks started dropping like flies. Hundreds failed between 1982 and 1993. Then, just like that, almost none failed for the next decade or so. Then, as we know, back again to a rash of failures starting in 2008.

So it's hard to find a pattern of failures just based on the numbers. Perhaps the pattern is that rashes of failures are random. Probably not, since there are other things happening.[2]

Congress became active following the recent collapse of the housing market and all that followed. It passed the Dodd-Frank Act, a massive cluster of laws, imposing an even more massive set of regulations to be promulgated over a number of years by a variety of agencies.[3] And following up on the discovery that threatening lawsuits can produce not only favorable political

[2] See Manias, Panics and Crashes by Charles Kindleberger, a book that should be required reading for every staff member of every Member on either financial services committee of Congress.

[3] DFA may prove to be the signature example of Congress passing the buck to the regulators to make policy decisions. Sometimes (see the Ability to Repay language in the residential mortgage title combined with the aggressive Fair Lending enforcement speeches) Congress and the Administration created an impossible scenario for regulators — make lending totally safe, but make sure all segments of society can get loans.

headlines but money for cash strapped states, Attorneys General and other state officials mimicked the example of the Federal Government and passed their own laws and regulations. They also began creative lawsuits against financial services firms. Even municipalities got into the act.[4]

But this isn't the first time that has happened. For many observers who read a greater span of history, the passage of the Bank Holding Company Act of 1956 and its amendments, designed to stop the unregulated spread of conglomerate holding companies controlling banks, was probably just as significant. Certainly the Financial Institutions Reform, Recovery and Enforcement Act of 1989, following the total collapse of the savings and loan association industry, was viewed as creating a paradigm shift, and the follow up passage of acts such as the Federal Deposit Insurance Corporation Improvement Act (new regulatory and capital requirements in 1991), the Reigle-Neal Act (interstate banking in 1994), and Gramm-Leach-Bliley (elimination of the Glass-Steagall barrier in 1999) were all touted as the final word for banking legislation. Having new and mind stretching legislation is not new.

There is a modest correlation between passage of these acts and what happens later in the economy of the country, but passage of legislation by itself is usually not enough to make a catastrophic impact on lending or structure. Of course, the Bank Holding Company Act of 1956 and its amendments certainly did. It blew up Transamerica and similar massive conglomerate companies and led to a much more regulated financial industry than otherwise would have existed. Reigle-Neal did by eliminating local anticompetitive fiefdoms, although compacts between groups of states was already leading to a great deal of interstate banking (always excluding New York with its giant banks, however). Even GLBA only endorsed what already was happening with the expansion of the Sec. 20 securities subsidiaries that were close to making a mockery of the Glass-Steagall barriers.[5]

One could argue that general and specific movements of various sectors within the economy had a much more significant impact. For example, the oil embargo increased all prices and caused massive economic disruptions,

[4] See the San Bernardino eminent domain resolution, and the disastrous impact that would have on that county and other similarly situated municipalities.

[5] It also permitted the merger of taxpayer protected downside with the high-risk culture of investment banking. The protection that partnerships previously provided to that culture — the partners' money was at risk — was eliminated. Firms continue to wrestle with the best way to deal with that.

and attempts to fight inflation and unemployment, and both control money supply and interest rates led to stunning numbers for a period of time (1982 unemployment of 10.8 percent; 1980 inflation of 13.5 percent; 1982 prime interest rate of 21.5 percent). The repercussions of those events were the significant factors. More recently, the ability of smaller global economies to produce large quantities of material and services demanded by first world countries (and with much lower labor rates but still high quality work) led to a new stockpile of liquidity in countries not accustomed to dealing with that. They looked to productive secure investments, and relied upon the brand names of the credit rating agencies, as well as the sales pitches of the companies selling securities and the desire of investors to get the last dollar in their investments. A lot of new liquidity in that environment combined with reckless leveraging in the commercial, residential and government sectors in the major economies of the world, as well as a fine portion of greed among senior officers not required to show sustainable results to get their bonuses, led to the mess.[6]

But there are business cycles, there always have been business cycles, there always will be business cycles. They are not necessarily bad — Schumpeter called them creative destruction — since the sickly participants are weeded out by the stronger ones, and society as a whole advances. Of course, it is not wise to ignore the transition to the "better world." The transition matters, or as Keynes said — in the long run we are all dead. In the current economy, we have been bumping along in the transition and still haven't seen the better world.

But more than that has happened. There have been dramatic changes in the way businesses and individuals find their financing. Starting with such changes as certificates of deposit and commercial paper, and moving on to securitization of consumer debt and the explosion of the derivatives market, along with the importation into the world of finance of a mathematics approach to the definition and measurement of risk — everyone had their own secret algorithm — the result is a much more complicated world of finance. It isn't the banking business that your father knew so well. Take for one example, mortgage servicing rights. They once were assets highly sought by

[6]Bonuses were rewarded throughout the industry based on short-term analysis of profits, not on the analysis of the sustainability of the performance to continue to provide profits for the company. Requiring no performance payments until passage of an appropriate period of time by itself would have mitigated the severity of the recent mortgage-based collapse.

some and traded easily. Now with new capital rules, they no longer are such desirable assets. Or take synthetic derivatives; real assets are not required as the source of trades — synthetic assets will do fine. None of this even takes into account the globalization of finance — all countries of the world can roll out tough competitors. Nor does it consider the increase in the use of technology and the risks and rewards that it provides, the importance of fee-based income, or the increasing requirements of more capital. The world of banking has changed by factors of ten, not by unitary increments.

For banks, they face new and agile competitors, some extremely large and knowledgeable. In many respects those competitors are free from many of the constraints banks face. Money market funds became a trillion dollar industry because banks and thrifts were locked into below market interest rates by statutory law and by Reg Q, and neither Congress nor the regulators were interested enough to change the regulation in time to avoid that result. Once the funds learned how to permit withdrawal by check, the game was up. In that case, government inaction created a major competitor for the old banking system.

But still, back to Schumpeter. Maybe that result is not all bad from the perspective of the customers. They got market interest rates, an eager and fresh thinking customer oriented party with whom to deal, and additional choices for their "banking" services. Derivatives opened up financing in ways that could be done conservatively and in beneficial ways that had no real competitor among the methods that now exist. Prospects for PTP banking have not developed rapidly, but it is an experiment that technology has permitted. It is not necessarily a bad idea to create a federal agency devoted to protecting consumers. A little appreciated secret in the U.S. is that new entrants into the banking sector have continued.[7]

The point of this is that there is no silver bullet, either in discovering causes of economic problems or creating solutions. No one thing causes economic cycles, and the solutions that are best are those made not in the heat of the moment but after careful consideration of the causes of the particular cycle. What one congress and president might see as pivotal legislation for the country, may in fact be that but not in a good way.

[7] At least until the last couple of years. In 2010, only five new charters were approved, the first single digit number of new entrants since 1934, and in 2011, not a single new bank was chartered. Yet, between 1970 and 2005, over 7,000 new state and federal banking charters were approved.

Chances are slim that solving the problems of the last cycle will lead to prevention of problems in the next cycle, but chances are good that moving too quickly without all of the facts will lead to bad results.

The best that the government can do in most of these situations is the best that the men and women that operate it can while understanding that they are not infallible. For example, deciding that the men and women in charge at one point in time are the brightest there will ever be, and they should be permitted to fix in concrete public policy that certain banks should never be protected against failure is not a good idea — an escape hatch should always be available that permits other bright men and women in the future in different circumstances to assess the situation at that time. Believing that a mathematical formula mechanically applied is better at assessing risk than human consideration is arrogant and wrong. Assuming that we can predict bubbles and prevent them from bursting to the detriment of at least part of the economy has no foundation in history, and basing public policy heavily on that is a mistake.

The men and women who operate our government and private sector entities must read, understand, and take into consideration economics and history if they want to have the best chance of doing the best thing in their jobs. We should provide all the tools necessary to permit them to do that.

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