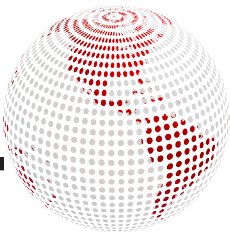

Why Financial Conglomerates Are at the Center of the Financial Crisis[1]

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The global economy is currently experiencing the "most severe financial crisis since the Great Depression." The ongoing crisis has battered global financial markets and has triggered a world-wide recession. Global stock market values declined by $35 trillion during 2008 and early 2009, and global economic output is expected to fall in 2009 for the first time since World War II.[3]

In the United States, where the crisis began, markets for stocks and homes have suffered their steepest downturns since the 1930s and have driven the domestic economy into a steep and prolonged recession. The total market value of publicly-traded U.S. stocks slumped by more than $10 trillion between October 2007 and February 2009. In addition, the value of U.S. homes fell by an estimated $6 trillion between July 2006 and the end of 2008. U.S. gross domestic product declined sharply during 2008 and the first quarter of 2009, and five million jobs were lost during the same period. Many sectors of the credit markets essentially ceased to function.[4]

The turmoil in global and domestic financial markets reflected deep concerns among investors about the viability of major financial institutions. Commercial and investment banks and insurance companies around the world reported more than $1.1 trillion of losses between August 2007 and March 2009. To prevent the collapse of the global financial system, central banks and governments in the United States (U.S.), United Kingdom (U.K.) and Europe provided almost $9 trillion of financial support in the form of emergency liquidity assistance, capital infusions, asset purchase programs, and guarantees. U.S. federal agencies extended about half of that support. Nevertheless, the ability of global financial markets to recover from the crisis remained in serious doubt in May 2009.[5]

As discussed below, seventeen major financial conglomerates account for a majority of the losses reported by global banks and insurers since the crisis began. In view of the huge losses suffered by these giant institutions, and the extraordinary governmental assistance they have received, they are clearly the epicenter of the crisis. They were also the primary private-sector catalysts for the credit boom that led to the crisis.

During the past two decades, governmental policies in the U.S., U.K. and Europe encouraged massive consolidation and conglomeration within the financial services industry. The Gramm-Leach-Bliley Act of 1999 (GLBA), which authorized U.S. banks to affiliate with securities firms and insurance companies,

was part of a strong international regulatory trend in favor of universal banks.[6] Domestic and international mergers among commercial and investment banks and insurers produced a dominant group of large complex financial institutions (LCFIs). By 2007, seventeen LCFIs effectively controlled domestic and global markets for debt and equity underwriting, syndicated lending, asset-backed securities (ABS), over-the-counter (OTC) derivatives, and collateralized debt obligations (CDOs).[7]

Universal banks exploited their dominance of global financial markets by pursuing an "originate-to-distribute" (OTD) strategy. The OTD strategy included (i) originating and servicing consumer and corporate loans, (ii) packaging those loans into ABS and CDOs, (iii) creating additional financial instruments, including credit default swaps (CDS) and synthetic CDOs, whose values were derived in complex ways from the underlying loans, and (iv) distributing the resulting securities and financial instruments to investors. LCFIs used the OTD strategy to maximize their fee income, reduce their capital charges, and transfer to investors (at least ostensibly) the risks associated with securitized loans and other structured-finance products. However, because many financial conglomerates followed similar OTD strategies, their common exposures to a variety of financial risks – including credit risk, market risk and liquidity risk – produced a significant rise in systemic risk in global financial markets.[8]

Even before the subprime lending boom began in 2003, some observers raised questions about the risks and conflicts of interest created by the new universal banks. For example, LCFIs played key roles in promoting the dotcom-telecom boom in the U.S. stock market between 1994 and 2000, which was followed by a devastating bust from 2000 to 2002. Many leading universal banks were also involved in a series of scandals involving Enron, WorldCom, investment analysts, initial public offerings, and mutual funds during the same period. However, Congress did not seriously consider whether financial conglomerates posed a serious threat to the stability of financial markets and the general economy. Instead, political leaders assumed that federal regulators and market participants would exercise sufficient control over universal banks.[9]

"Seventeen major financial conglomerates account for the majority of losses reported by global banks and insurers." since the crisis began."

The U.S. experienced an enormous credit boom between 1991 and 2007. Household debt rose by $10 trillion (to $13.8 trillion), nonfinancial business debt grew by $6.4 trillion (to $10.1 trillion), and financial sector debt increased by $13 trillion (to $15.8 trillion). As a result of this credit boom, the financial services industry captured an unprecedented share of corporate profits and gross domestic profit. Governmental policies (including the Federal Reserve's overly expansive monetary policy, as well as currency exchange rate policies pursued by foreign governments) were important factors that encouraged credit growth within the U.S. At the same time, universal banks were the leading private-sector catalysts for the credit boom.[10]

During the boom, LCFIs used nationwide mass marketing, automated loan processing, and securitization to provide huge volumes of high-risk home mortgage loans and credit card loans to nonprime borrowers. The federal government facilitated the creation of nationwide consumer lending programs by LCFIs, because federal laws preempted state usury laws and other state laws that had traditionally shielded consumers from predatory lending. Unfortunately, Congress and federal regulators failed to establish adequate safeguards to protect consumers against abusive lending practices by federally

chartered depository institutions and their subsidiaries and agents.[11]

Originations of nonprime mortgages rose from $250 billion in 2001 to $1 trillion in 2006. Nearly 10 million nonprime mortgages were originated between 2003 and mid-2007. LCFIs used securitization to spur this dramatic growth in nonprime lending. By 2006, more than four-fifths of nonprime mortgages were packaged by LCFIs into residential mortgage-backed securities (RMBS). As the securitized share of nonprime lending increased, lending standards deteriorated. For example, lenders increasingly offered subprime mortgages with low "teaser rate" payments for two or three years, followed by a rapid escalation of interest rates and payments. As a practical matter, subprime borrowers were forced to refinance their loans before the "teaser rate" period expired, and refinancing was possible only as long as home prices kept rising. LCFIs effectively created a system of "Ponzi finance," in which nonprime borrowers had to keep taking out new loans to pay off their old ones. When home prices stopped rising in 2006 and collapsed in 2007, nonprime borrowers were no longer able to refinance their debts. Mortgage defaults skyrocketed, and the subprime financial crisis began.[12]

Financial conglomerates aggravated the risks of nonprime mortgages by creating additional financial bets based on those mortgages. LCFIs re-securitized lower-rated tranches of RMBS to create CDOs, and then re-securitized lower-rated tranches of CDOs to create CDOs-squared. LCFIs also wrote CDS and synthetic CDOs to create additional financial bets based on nonprime mortgages. By 2007, the total volume of financial instruments derived from nonprime mortgages was more than twice as large as the $2 trillion in outstanding nonprime mortgages. LCFIs persuaded regulators and credit rating agencies that the securitization process transferred the risks of nonprime lending to far-flung investors. In fact, however, LCFIs retained significant exposures to nonprime mortgages because (i) LCFIs kept RMBS and CDOs in their "warehouses," and (ii) LCFIs transferred RMBS and CDOs to off-balance-sheet conduits that relied on the sponsoring LCFIs for explicit or implicit financial support. Thus, many LCFIs pursued an "originate to *not really* distribute" strategy, because they retained significant residual risks in order to complete more transactions and earn more fees.[13]

Universal banks created similar risks

with their credit card operations. While the housing boom lasted, universal banks aggressively expanded credit card lending to nonprime borrowers and encouraged borrowers to use home equity loans to pay off their credit card balances. As in the case of nonprime home mortgages, LCFIs discounted the risks of nonprime credit card loans as long as they could securitize most of the loans. The securitization market for credit card loans shut down in 2008, just as it had done for subprime mortgages in 2007, leaving LCFIs with large exposures to nonprime loans.[14]

Universal banks also pursued reckless lending policies in the commercial real estate and corporate sectors. LCFIs used securitization techniques to promote a dramatic increase in commercial mortgage lending and leveraged corporate lending between 2003 and mid-2007. LCFIs used many of the same risky loan terms (including interest-only provisions and high loan-to-value ratios) for commercial mortgages and leveraged corporate loans

that they used for nonprime home mortgages. In all three markets, securitization created perverse incentives for universal banks. LCFIs believed that they could (i) originate risky loans without properly screening borrowers and (ii) avoid costly post-loan monitoring of the borrowers' behavior, as long as the loans were securitized and transferred to investors. However, LCFIs often retained exposures to residual risks. This was particularly true in the market for leveraged corporate buyouts (LBOs), because LCFIs frequently agreed to provide "bridge" financing if they could not locate enough investors to fund the deals. Once again, the ability of LCFIs to control their risks was undercut by their emphasis on maximizing transactions and fees. When the securitization markets for commercial mortgages and leveraged corporate loans collapsed in mid-2007, universal banks were exposed to significant losses in addition to their problems with nonprime consumer credit.[15]

The huge losses reported by financial conglomerates since the outbreak of the financial crisis demonstrate that (i) LCFIs were leading catalysts for the credit boom that led to the crisis, and (ii) LCFIs are the epicenter of the crisis. Between August 2007 and April 2009, commercial and investment banks incurred more than $910 billion of losses, and insurance companies suffered an additional $220 billion of losses.[16] More than half of those losses were reported by seventeen of the world's leading financial conglomerates.[17]

Thirteen of those seventeen conglomerates suffered severe damage. Of those thirteen LCFIs, (ii) six institutions (AIG, Bear Stearns, Lehman Brothers, Merrill Lynch, RBS and Wachovia) either failed or disappeared in government-assisted mergers or were nationalized; (iii) three institutions (BofA, Citigroup and UBS) continue to operate under private management but with government-funded life support and close supervision; and (iii) four other institutions (Barclays, Goldman Sachs, HSBC and Morgan Stanley) reported serious losses and were forced to make major changes to their operations.

Governments and financial regulators took extraordinary steps to prop up their leading financial institutions. In April 2009, the International Monetary Fund (IMF) reported that U.S., U.K. and European central banks and governments had provided nearly $9 trillion of support to financial institutions, including $2 trillion of emergency central bank liquidity assistance, $2.5 trillion of government asset purchase commitments, and almost $4.5 trillion of financial guarantees. U.S. authorities extended about half of that support.[18]

The current crisis has revealed a stunning failure of financial regulation. During the past two decades, regulators in developed nations (particularly the U.S. and U.K.) generally implemented the following policies:

- To rely primarily on market mechanisms and "soft" supervisory guidance as methods for directing and restraining the conduct of LCFIs, while reducing the use of binding regulations (including consumer protection laws);
- To promote the use of quantitative risk models as substitutes for traditional methods of evaluating the risks of customers and financial institutions;
- To encourage LCFIs to replace traditional methods of credit intermediation – in which banks screen and monitor borrowers and hold loans on their balance sheets – with an OTD strategy that transferred loans to widely dispersed investors who had little opportunity to evaluate the creditworthiness of borrowers;
- To encourage LCFIs to pursue additional fee-based business lines tied to the capital markets; and
- To promote continued consolidation within the financial services industry, based on the belief that larger and more diversified financial conglomerates offered greater safety and profitability.

Critics have alleged that the foregoing regulatory policies actually impaired the safety of financial institutions and undermined the

stability of financial markets, because such policies encouraged:

> An excessive reliance on quantitative, market-sensitive measures of risk and capital, which accentuated booms and aggravated busts in the business cycle;
>
> An overuse of structured-finance securitizations and OTC derivatives, which created complex and opaque risk exposures and a fragile web of interconnections among LCFIs and various sectors of the financial markets;
>
> A greater dependence by LCFIs on funding from the capital markets, which increased the vulnerability of the financial system to liquidity shortages and panics;
>
> A failure to restrain the growth of systemic risk within LCFIs; and
>
> A misplaced confidence in market discipline as an effective restraint on excessive risk-taking and abusive practices by LCFIs.[xix]

With respect to the last criticism, observers have pointed out that market discipline is inherently procyclical and is too lax during euphoric "bubbles" and too extreme during panic-induced "busts." The effectiveness of market discipline is also undermined by self-reinforcing herd and momentum effects, which cause market participants to follow the herd even when they have doubts about the wisdom of the course the herd is pursuing.

Two striking examples of the power of herd mentality appeared in statements made by the chief executive officers of BofA and Citigroup shortly before the financing boom for LBOs collapsed in the late summer of 2007. In May 2007, Kenneth Lewis boasted during a speech that BofA had participated in seven of the 15 largest LBOs during that year. However, during the question-and-answer period following his speech, Mr. Lewis acknowledged that "[w]e are close to a time when we'll look back and say we did some stupid things. . . . We need a little more sanity in a period in which everyone feels invincible."[21] Two months later, Chuck Prince of Citigroup famously declared during an interview with the *Financial Times* that "[w]hen the music stops, in terms of liquidity, things will be complicated. But, as long as the music is playing, you have got to get up and dance. We are still dancing."[22] Thus, even the top executives of the largest banks in the world felt compelled to follow the herd.

The past two years have witnessed an unprecedented expansion of governmental support for LCFIs. In an article published in 2002, I maintained that the "too big to fail" (TBTF) policy was "the great unresolved problem of bank supervision."[23] I argued that the passage of GLBA made the TBTF problem much worse, because GLBA's authorization of financial holding companies increased the likelihood that "major segments of the securities and life insurance industries will be brought within the scope of the TBTF doctrine, thereby expanding the scope and cost of federal 'safety net' guarantees."[24] I also warned that the risk control measures relied upon by GLBA's supporters – including market discipline – were plainly inadequate.[25] I predicted that the new financial holding companies would successfully exploit TBTF subsidies because "the unmistakable

Four months after the interview, Chuck Prince was no longer "dancing" as the CEO and Chairman of Citigroup.

lessons of the past quarter century are that (i) regulators will protect major financial firms against failure whenever such action is deemed necessary to preserve the stability of financial markets; and (ii) financial institutions will therefore pursue riskier and opaque activities and will increase their leverage, through capital arbitrage, if necessary, as they grow in size and complexity."[26]

The current financial crisis has confirmed all of the foregoing predictions. During the past decade, regulators in developed nations encouraged the expansion of large financial conglomerates and failed to restrain their pursuit of short-term profits through increased leverage and high-risk activities. LCFIs were allowed to promote an enormous credit boom that led to a worldwide financial crisis. In order to prevent a complete collapse of global financial markets, governments adopted extraordinary measures to support major banks, securities firms and insurance companies. Those support measures, which are far from over, establish beyond any doubt that the TBTF policy now covers the entire financial services industry.[27] Consequently, one of the most pressing policy imperatives is to reform the regulation of financial institutions and financial markets with the goal of (i) eliminating TBTF subsidies and their moral hazard effects, and (ii) establishing effective restraints on risk-taking by LCFIs.

Endnotes

1 This essay is adapted from portions of the following article: Arthur E. Wilmarth, Jr., The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis, 41 Conn. L. Rev. 963 (2009), available at http://ssrn.com/abstract=1403973.
2 Markus K. Brunnermeier, Deciphering the Liquidity and Credit Crunch, 2007–08, 23 J. Econ. Perspectives No. 1, at 77, 77 (Winter 2009).
3 Wilmarth, supra note 1, at 966-67.
4 Id. at 967-68; James C. Cooper, The Great Adjustment Is Well Under Way, Bus. Wk., April 13, 2009, at 6.
5 Wilmarth, supra note 1, at 968, 1043-46.
6 Id. at 972-80. As used in this essay, the term "universal bank" refers to an organization that has authority to engage, either directly or through affiliates, in the banking, securities and insurance businesses. See Arthur E. Wilmarth, Jr., The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation, and Increased Risks, 2002 U. Ill. L. Rev. 215, 223 n.23, available at http://ssrn.com/abstract=315345. In addition, the terms "universal bank," "financial conglomerate" and "large complex financial institution" are used interchangeably.
7 Wilmarth, supra note 1, at 980-95.
8 Id. at 994-97, 1020-37.
9 Id. at 996-1002.
10 Id. at 1002-12.
11 Id. at 1011-15, 1035-36.
12 Id. at 1015-27.
13 Id. at 1027-35.
14 Id. at 1035-37.
15 Id. at 1037-43.
16 Id. at 1043-44.
17 See id. at 994-95 (explaining that, in 2007, the world's leading financial conglomerates included (i) the four largest U.S. banks – Bank of America (BofA), JP Morgan Chase, Citigroup and Wachovia; (ii) the five largest U.S. securities firms – Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley; (iii) seven major foreign universal banks – Barclays, BNP Paribas, Credit Suisse, Deutsche Bank, HSBC, Royal Bank of Scotland (RBS), Societe Generale and UBS; and (iv) American International Group (AIG), the largest U.S. life insurer and second largest U.S. property and casualty insurer). By April 2009, AIG had recorded $87.3 of losses resulting from the financial crisis, compared to $544 billion of losses for the remaining 16 institutions. Id. at 1044 n.423.
18 Id. at 1044-46.
19 Id. at 1047-48; see also Daniel K. Tarullo, Banking on Basel: The Future of International Financial Regulation 98-108, 120-21, 131-35, 139-41, 149-90 (2008) (criticizing the Basel II capital accord, particularly the accord's heavy reliance on quantitative risk-based models developed by LCFIs).
20 Arthur E. Wilmarth, Jr., How Should We Respond to the Growing Risks of Financial Conglomerates?, in Financial Modernization After Gramm-Leach-Bliley 65, 110-13 (Patricia A. McCoy ed. 2002); see also Robert J. Shiller, Irrational Exuberance (2d ed. 2005), esp. at 157-72..
21 Greg Ip, Fed, Other Regulators Turn Attention to Risk in Banks' LBO Lending, Wall St. J., May 18, 2007, at C1 (quoting Mr. Lewis' remarks as reported by Bloomberg News).
22 Counting the reasons not to be cheerful, Investment Adviser (FT Business), July 23, 2007 (quoting from Mr. Prince's interview).
23 Wilmarth, supra note 6, at 475.
24 Id. at 446-47.
25 Id. at 454-75.
26 Id. at 476.
27 Wilmarth, supra note 1, at 1049-50. The comprehensive reach of the TBTF policy is confirmed by the federal government's recently-completed "stress test" for the 19 largest U.S. banking organizations (each with more than $100 billion of assets). In announcing the "stress test," regulators emphasized that none of the banks would be allowed to fail the test, because the federal government would provide any capital that was needed to ensure the survival of all 19 banks. Id. at 1050 n.449.

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"Foreclosure." Flickr. 29 Oct. 2009. http://www.flickr.com/photos/respres/2539334956/sizes/l/
"Chuck Prince, ex-CEO of Citigroup." Wikimedia.. 29 Oct 2009. http://upload.wikimedia.org/wikipedia/commons/e/e2/Prince25012007.jpg