GLASS-STEAGALL THROUGH THE BACK DOOR: CREATING A DIVIDE IN BANKING FUNCTIONS THROUGH THE USE OF CORPORATE LIVING WILLS

Roshni Banker*

* J.D. Candidate 2011, Columbia University School of Law; B.A. Government 2006, Dartmouth College. The author would like to thank Professor Merritt Fox for his guidance, Bryant Lee and the Survey Team for their feedback and support, and the staff of the *Columbia Business Law Review* for its editing assistance.

I. INTRODUCTION

The United States is currently in the midst of the worst financial crisis since the Great Depression.[1] Many have ascribed the failure of markets in large part to weaknesses in financial supervision and regulation by a flawed system, operating under an outmoded conception of systemic risk.[2] The debate on modernizing financial regulation that has emerged, however, finds several regulators, academics, and experts seeking to turn back the clock to the New Deal era by reimposing the firewalls between commercial and investment banking mandated by the Glass-Steagall Act of 1933 and repealed by the Gramm-Leach-Bliley Act in 1999. Proponents of this view cite deregulation, not poor regulation, as the root of the financial crisis.[3]

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[1] *See, e.g.*, Peter Goodman, *The Financial Crisis and America's Casino Culture*, N.Y TIMES, Sept. 20, 2009, at WK1. *But see* Joshua Zumbrun, *Greenspan Says Crisis 'By Far' Worst, Recovery Uneven,* BLOOMBERG, http://www.bloomberg.com/apps/news?pid=20601087&sid=a4lpUmEdbebw (quoting former Federal Reserve Chairman Alan Greenspan as describing the current financial crisis as the worst in American history).

[2] *See, e.g.*, Timothy Geithner and Lawrence Summers, *A New Financial Foundation*, WASH. POST, June 15, 2009, at A15 ("This current financial crisis had many causes. . . . But it was also the product of basic failures in financial supervision and regulation. Our framework for financial regulation is riddled with gaps, weaknesses and jurisdictional overlaps, and suffers from an outdated conception of financial risk."); *The Causes and Current State of the Financial Crisis: Hearing Before the Financial Crisis Inquiry Commission*, 111th Cong. 1–2 (2010), *available at* http://www.fcic.gov/hearings/pdfs/2010-0114-Bair.pdf (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation) [hereinafter *Bair Statement*] ("[A]t the onset of the crisis, it's been estimated that half of all financial services were conducted in institutions that were not subject to prudential regulation and supervision. . . . The financial crisis calls into question the fundamental assumptions regarding financial supervision, credit availability, and market discipline that have informed our regulatory efforts for decades.").

[3] *See, e.g.*, Amar Bhide, *Why Bankers Got Reckless*, BUS. WK., Feb. 9, 2009, at 31 ("To prevent future meltdowns, let's revive the radical idea of narrow commercial banking. Let's tightly limit bank activity to taking deposits and making loans—loans that bankers and regulators who aren't theoretical mathematicians can monitor. . . . Anyone else—investment

In a time of too-big-to-fail institutions requiring bailouts funded by taxpayer dollars, assaults on commercial banking's diversification beyond traditional lending are a popular response.[4] Those who call for a "Glass-Steagall Act for the 21st Century" hope to reregulate the boundary between the "casino" and "utility" functions of financial institutions through new rules prohibiting deposit-taking entities from engaging in investment banking activity.[5] Arguing that Congress should never have abandoned these measures in the first place, advocates of this position believe that such a divide is the best way to prevent future financial meltdowns, protect depositors, limit the spread of risk, and allow for more focused regulatory oversight.[6]

However, the argument that the repeal of the Glass-Steagall Act was one of the primary causes of the financial crisis, and the accompanying proposals calling for its resurrection, fail to recognize the Act's limited utility in addressing the modern boundary problem in banking

banks, hedge funds, trusts—would be allowed to innovate and speculate, free of additional oversight."); Nouriel Roubini, *'Too Big to Fail' Revisited*, FORBES.COM, Nov. 5, 2009, http://www.forbes.com/2009/11/04/too-big-to-fail-volcker-greenspan-mervyn-king-opinions-columnists-nouriel-roubini.html ("A separation of commercial banking and risky investment banking should also be considered. Thus, some variant of the Glass-Steagall Act should be reintroduced. . . . Advocates of this solution include Paul Volcker (who chaired the Group of Thirty report) and Mervyn King (Governor of the Bank of England).").

[4] Paul Volcker, *How to Reform Our Financial System*, N.Y. TIMES, Jan. 31, 2010, at WK11 ("[S]ome of the largest and proudest financial institutions—including both investment and commercial banks—have been rescued or merged with the help of massive official funds. Those actions were taken out of well-justified concern that their outright failure would irreparably impair market functioning and further damage the real economy already in recession"); Bhide, *supra* note 3, at 30 ("Commercial banking's diversification, its expansion beyond traditional lending, has been disastrous.").

[5] Bhide, *supra* note 3, at 30 ("What's needed now is a Glass-Steagall Act for the 21st Century—rules requiring banks to focus simply on taking deposits and granting loans.").

[6] *Id.* (arguing that a return to narrow banking would "protect depositors, limit financial-risk contagion, and allow the FDIC and the Federal Reserve to do what they do best").

regulation.[7] Where the very consolidation of commercial and investment banking prevented the failure of standalone banks in the wake of the financial crisis, (for example, the recent mergers of Bear Stearns and J.P. Morgan Chase and of Merrill Lynch and Bank of America), falling back on the Act's provisions highlights the lack of an improved regulatory solution to address the concern about banks that are too big to fail.[8]

This Note argues that regulations on the size and scope of banking activities, while certainly a popular response to the financial crisis, may not be as practical in addressing the problem of too-big-to-fail institutions as regulation directly targeting the interconnectedness and complexity of modern

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[7] *See* ABA BANKING LAW COMMITTEES/TASK FORCE ON REGULATORY REFORM, THE FINANCIAL CRISIS OF 2007-2009: CAUSES AND CONTRIBUTING CIRCUMSTANCES 6, (Sept. 2009), *available at* http://www.abanet.org/buslaw/committees/CL130055pub/materials/201001/causes-report.pdf [hereinafter CAUSES AND CONTRIBUTING CIRCUMSTANCES] ("Viewed in a historical perspective, the financial crisis suggests that banking regulators were overly optimistic about the ability of banking organizations to manage the transformation from traditional banking functions to sophisticated, full-service financial institutions operating broadly in nontraditional markets. Yet, we found no reason to suggest that the evolution of the banking system to its present form should—or can—be reversed to an earlier time."); *see also* FINANCIAL SERVICES AUTHORITY, THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 95, (2009), *available at* http://www.fsa.gov.uk/pubs/other/turner_review.pdf [hereinafter TURNER REVIEW] ("It does not therefore seem practical to work on the assumption that we can or should achieve the complete institutional separation of 'utility banks' from 'investment banks' which the advocates of that model suggest. Large complex banks spanning a wide range of activities are likely to remain a feature of the world's financial system.").

[8] Charles Calomiris, *Most Pundits Are Wrong About the Bubble,* WALL ST. J., Oct. 18, 2008, at A13 ("Wasn't the ability for commercial and investment banks to merge (the result of the 1999 Gramm-Leach-Bliley Act, which repealed part of the 1933 Glass-Steagall Act) a major stabilizer to the financial system this past year? Indeed, it allowed Bear Stearns and Merrill Lynch to be acquired by J.P. Morgan Chase and Bank of America, and allowed Goldman Sachs and Morgan Stanley to convert to bank holding companies to help shore up their positions during the mid-September bear runs on their stocks.").

financial architecture.[9] Instead of requiring a legal separation of the deposit-taking and proprietary-trading activities of banks, the creation of corporate living wills, subject to regulatory oversight, would require an internal simplification of organizational structure and the ring-fencing of safer, more essential functions of a banking utility from its riskier, speculative counterparts, increasing transparency to allow for a more orderly wind-down process in event of failure.[10] The result would effect a private-sector version of the Glass-Steagall Act, internally imposed by the institutions themselves.[11]

This Note traces the path from the enactment of Glass-Steagall and its subsequent demise to calls for its revival, and provides an alternate method to reach a similar end. Part II explores the background of the Glass-Steagall Act and its eventual repeal. Part III evaluates the current proposals to regulate the banking industry. Part IV presents the idea of corporate living wills and argues that they may incentivize internal regulation of the boundary between commercial and speculative banking to create a change in financial structure through the ring-fencing of risky

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[9] *See Bair Statement, supra* note 2, at 36 ("Why are these firms too big to fail? These firms have become highly leveraged and massively complex with multiple financial subsidiaries, extensive off-balance-sheet activities and opaque financial statements. These expansive inter-connected structures were managed as if they were a single entity, ignoring the corporate legal separateness of their many subsidiaries. In addition, these firms were highly interconnected through their capital-markets activities, such as derivates, private-label MBSs and structured-debt issuance.").

[10] *See id.* at 40 ("Large interconnected firms should also be required to develop their own liquidation plan—a living will so to speak—which would demonstrate that they could be broken apart and sold in an orderly manner. An approved liquidation plan would result in greater legal, and, in particular, functional separation of affiliates within these large financial holding companies and greater autonomy and firewalls surrounding insured banks.").

[11] Editorial, *Death Warmed Up,* THE ECONOMIST, Oct. 3, 2009, at 39 ("Ringfencing [sic] deposits in anticipation of a bank failure would come close to a stealthy reimposition of Glass-Steagall, the 1933 American law which separated commercial and investment banking and was repealed in 1999.").

activities. Part V concludes with a discussion of the advantages of this approach in an environment dominated by a small number of systemic institutions.

II. BACKGROUND: GLASS-STEAGALL TO GRAMM-LEACH-BLILEY

In the aftermath of the 1929 stock market crash and nationwide bank failures, Congress enacted the Glass-Steagall Act, mandating a separation between the commercial and investment banking functions of financial institutions.[12] The provisions of the act were gradually eroded through the mid-1990's, culminating in the passage of the Gramm-Leach-Bliley Act ("GLBA"), which allowed, once again, affiliation between deposit-taking and speculative activity.[13]

A. The Glass-Steagall Act

Following the banking crisis of 1929-1933, Congress passed a series of financial reforms intended to restore confidence in the banking system.[14] Most notably, the Banking Act of 1933 created the Federal Deposit Insurance Corporation ("FDIC"), which insured deposits at qualified member banks; prohibited banks from paying interest on demand deposits (e.g., traditional checking accounts); authorized the Federal Reserve to set interest-rate ceilings on savings accounts; expanded national banks' branching powers; and introduced regulation of bank holding

[12] Glass-Steagall Act, Pub. L. No. 73-66, 48 Stat. 162 (1933) (codified in various sections of 12 U.S.C.) (partially repealed in 1999 by the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999)); *see also* RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 18 (4th ed. 2009) (providing a historical overview of banking regulation in the United States).

[13] Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999); *see also* CARNELL ET AL., *supra* note 12, at 27 (discussing the gradual dismantling of the New Deal banking structure and noting that "the once formidable wall between commercial and investment banking fell after a long bombardment").

[14] CARNELL ET AL., *supra* note 12, at 16–17.

companies (mandating Federal Reserve-approved permits in certain instances and limiting bank transactions with affiliates).[15] The act also adopted four provisions known as the Glass-Steagall Act, mandating the separation of commercial and investment banks: (1) Section 16 limited banks that deal in securities to purchases or sales solely for customer accounts (with certain exceptions); (2) Section 20 prohibited commercial banks from affiliation with any entity "engaged principally" in the underwriting or public sale of securities; (3) Section 21 prohibited any entity engaged in issuing, underwriting, or distributing securities from also receiving deposits; and (4) Section 32 prohibited relationships between commercial banks and securities firms "primarily engaged" in the underwriting or distribution of securities.[16] The Bank Holding Company Act of 1956 further strengthened these divisions by extending the restrictions on banks to cover bank holding companies owning two or more banks.[17]

Largely in response to the conflicts of interest created when commercial banks underwrite stock or bonds (one of the perceived causes of the financial crisis of the 1930s), Glass-Steagall forced banks to choose between acting either as a lender or a broker.[18] Under the Act, banks had one year to decide whether to remain in the securities business—and thereby forego the safety net of deposit insurance and the low-interest credit of the Federal Reserve—or exit and access

[15] Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (1933) (provisions of which are also known as the Glass-Steagall Act); *see also* CARNELL ET AL., *supra* note 12, at 18–19.

[16] *See* 12 U.S.C. § 24 (Seventh) (2008); 12 U.S.C. § 377, *repealed by* Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, Title 1, § 101(a) 113 Stat. 1338, 1341; 12 U.S.C. § 378 (2010); 12 U.S.C. § 78, *repealed by* Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, Title I, § 101(b), 113 Stat. 1338, 1341; *see also* CARNELL ET AL., *supra* note 12, at 18 (discussing the provisions of the Banking Act of 1933).

[17] Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133 (1956) (requiring Federal Reserve Board approval for the establishment of a bank holding company); *see also* CARNELL ET AL., *supra* note 12, at 22.

[18] CARNELL ET AL., *supra* note 12, at 17–18.

those benefits.[19] The congressional intent was to protect deposits and the newly-created deposit-insurance fund from misuse in support of securities-related activities.[20] Glass-Steagall's divide between commercial and investment banking activity was designed to restore confidence in the U.S. financial system.[21] "By placing bankers and brokers in 'separate rooms,'" it was believed that the abuses that led to the banking crisis of 1929 would be curtailed.[22] Moreover, Congress intended the separation to protect the federally insured deposits of ordinary citizens from speculative activity.[23]

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[19] *Id.*; *see also* 12 U.S.C. § 378(a) (2010) (noting that banks had one year from the time of Glass-Steagall's enactment to reorganize).

[20] *See* S. REP. NO. 77, 6–7, 9–10 (1933) (noting the purpose of the Bank Holding Company Act was "[t]o provide for the safer and more effective use of the assets of Federal reserve banks and . . . to prevent the undue diversion of funds into speculative operations . . . ").

[21] *See, e.g.*, Curtis J. Polk, *Banking and Securities Law: The Glass-Steagall Act—Has it Outlived its Usefulness?*, 55 GEO. WASH. L. REV. 812, 813–814 (noting that "[t]o rebuild public confidence in the banking system, Congress intended Glass-Steagall to be a prophylactic measure divorcing commercial banking from investment banking"); *see also* 7 THOMAS HAZEN, LAW OF SECURITIES REGULATION § 22.6 (6th ed. 2009) (citing Securities Indus. Assoc. v. Board of Governors, 807 F.2d 1052, 1069 (D.C. Cir. 1986)) ("In 1971, the Supreme Court identified the following 'financial dangers' that were sought to be avoided by the Glass-Steagall Act's separation of commercial banking from the securities industry: (1) the danger of investing bank deposits in securities, (2) the impetus for unsound loans that might be necessary to save an affiliate in the securities business, (3) *the risk of losing public confidence because of involvement in the more speculative securities industry*, (4) the temptation of making unsound loans to issuers whose securities were being underwritten, (5) the risk of loss to depositors, (6) the loss of banks' reputation for 'prudence and restraint,' (7) the temptation to make loans to customers to facilitate their purchases of securities, (8) conflicts of interest impairing the banks' ability to give disinterested investment advice, and (9) the potential misuse of funds managed by bank trust departments.") (emphasis added).

[22] KENNETH R. BENSON ET AL., FINANCIAL SERVICES MODERNIZATION: GRAMM-LEACH-BLILEY ACT OF 1999, 25 (CCH 1999).

[23] *See id.* ("In addition, the separation acted as a safe harbor for ordinary Americans, under which they could deposit their money safely, protected by deposit insurance and shielded from the more speculative nature of stocks.").

As a result of the separation between banking and securities underwriting, commercial banks initially confined themselves to the business of taking deposits and making loans (insured by the FDIC), and securities firms focused on obtaining funding through capital-markets activity or private short-term financing.[24] However, both entities soon began to engage in regulatory arbitrage to circumvent the artificial limitations imposed on their activities.[25] Their actions kick started efforts to loosen the restrictions of the Glass-Steagall Act.[26]

B. The Deregulation Wave

Lobbying efforts to limit the application of Glass-Steagall began not long after the Act's passage. By the 1960s,

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[24] *See* CADWALADER, WICKERSHAM & TAFT LLP, WHY ARE BANKING AND SECURITIES SEPARATED UNDER FEDERAL LAW? 1 (2008), *available at* http://www.cadwalader.com/assets/article/050108LofchieBankandSec.pdf (describing the immediate effects of Glass-Steagall).

[25] *See* CARNELL ET AL., *supra* note 12, at 29 (defining regulatory arbitrage as the process by which institutions "shift economic activity into the entities that enjoy the least regulations (or in some cases the greatest subsidy)"); *see also* CAUSES AND CONTRIBUTING CIRCUMSTANCES, *supra* note 7, at 4 ("Among other things, securities firms in the 1970's found ways of offering attractive alternatives to deposits and commercial loans. Insurance companies also broadened their offerings of financial products. These developments impelled banks to find ways of shedding old legal restrictions and offering more competitive products and services to retain their customers. Banking regulators permitted banks to expand into broader securities and insurance markets with wider geographic reach, sometimes relying on new legal theories. The securities and insurance industries fought back, often in the courts, which generally sided with the banking industry.").

[26] *See* CARNELL ET AL., *supra* note 12, at 71 ("Contending interest groups often have enough power to block hostile legislation but not enough to obtain desired legislation in the face of opposition from other groups. . . . Market, administrative, and judicial developments can facilitate legislation by so eroding old legal barriers that people lose interest in fighting for them. This sort of erosion opened the way for . . . the 1999 legislation allowing affiliations between banks and other financial institutions. The Glass-Steagall Act, once likened to a high stone wall, had become more akin to a screen door. It's one thing to defend castle battlements, but who ever fought for a screen door?").

commercial banks began to petition Congress to allow them to operate in the municipal-bond market, an investment activity.[27] By the 1970s, brokerage firms had started to offer money-market accounts, checking options, and a secondary market for commercial paper, thereby infringing on commercial banking functions.[28]

The anti-regulation movement had taken hold in Washington by the late 1980s and early 1990s.[29] In 1986, the Federal Reserve Board of Governors reinterpreted Section 20 of the Act to indicate that, in order to qualify as being principally engaged in securities activity and thereby be barred from commercial banking, more than 5 percent of the firm's gross revenue must derive from investment-banking activity.[30] The Federal Reserve later expanded upon this interpretation, allowing underwriting by a commercial bank which did not result in a significant source of revenue.[31] One year later, after extensive lobbying from Citicorp, J.P.

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[27] *See* João A. C. Santos, *Securities Activities in Banking Conglomerates: Should Their Location Be Regulated?*, 18 CATO JOURNAL 93, 105–106 (1998), *available at* http://ssrn.com/abstract=8423 ("In the 1960s, however, both sides began attempting to expand their activities into each other's strongholds. These attempts put pressure on the regulatory agencies to change some of the regulations under their control.").

[28] CAUSES AND CONTRIBUTING CIRCUMSTANCES, *supra* note 7, at 4 n.5 ("Securities brokers offered money market mutual funds and securities brokerage accounts with checking account features paying market rates of return whereas banks were prohibited from paying any interest on checking accounts or selling securities. The securities industry developed a secondary private placement market for commercial paper which allowed companies to raise operating funds directly in the capital markets more easily and cheaply than through bank loans.").

[29] ABA BANKING LAW COMMITTEES FINANCIAL RESTRUCTURING TASK FORCE, HISTORY AND BACKGROUND OF PREVIOUS REGULATORY REFORM AND RESTRUCTURING PROPOSALS, 13–23 (Draft - 7/29/09) [hereinafter HISTORY AND BACKGROUND OF PREVIOUS REGULATORY REFORM].

[30] *See* Ingo Walter, *The New Case for Functional Separation in Wholesale Financial Services*, 6–7 (Stern School of Business Finance Working Paper FIN-09-030, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1442148; *see also* Santos, *supra* note 27, at 106.

[31] Santos, *supra* note 27, at 106.

Morgan, and Bankers Trust to loosen the restrictions of Glass-Steagall, the Federal Reserve Board of Governors voted to allow banks to engage in certain securities underwriting activities, overriding opposition from then Chairman Paul Volcker.[32] The decision was followed by the 1989 approval of an application by the same coterie of banks to allow dealing in debt and equity securities in addition to municipal securities and commercial paper, and a subsequent order to raise the revenue limit to 10 percent of revenue.[33] In 1996, the Federal Reserve Board of Governors issued a decision raising the revenue limit again, now allowing bank holding companies to own investment bank affiliates with up to 25 percent of their business in securities underwriting, completing the gradual erosion of the prohibitions of Glass-Steagall.[34]

By the late 1990s, many of the primary functions of the Act had been rendered obsolete: banks were able to sell investment and insurance products, operate securities subsidiaries, and engage in other such activities.[35] Glass-Steagall, as it existed at the end of the decade, only minimally regulated the boundary between investment banking and deposit-taking activity.[36] The barriers between the two industries had been virtually eliminated.[37]

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[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] *See* CAUSES AND CONTRIBUTING CIRCUMSTANCES, *supra* note 7.

[36] Jonathan R. Macey, *The Business of Banking: Before and After Gramm-Leach-Bliley*, 25 J. CORP. L. 691, 691–692 (2000) ("Glass-Steagall was dead before Gramm-Leach-Bliley because federal regulators, particularly the Federal Reserve Board and the Comptroller, had already eviscerated the 'Maginot Line' between commercial and investment banking through liberal regulatory interpretations of the statute . . . .").

[37] *Id.* ("[O]ver time, banks and investment banks had conspired with compliant regulators to punch giant holes in the statutory restrictions on combining commercial banking and investment banking."); *see also* Edward J. Kane, *The Importance of Monitoring and Mitigating the Safety-Net Consequences of Regulation-Induced Innovation* 3 (Networks Financial Institute, Policy Brief 2009-PB-08), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1507802 ("[T]he *de jure* barriers between the

C. Financial Modernization and the Gramm-Leach-Bliley Act

On November 12, 1999, Congress enacted the Financial Modernization Act (more commonly known as the Gramm-Leach-Bliley Act), which repealed Sections 20 and 32 of the Glass-Steagall Act.[38] The GLBA's passage followed extensive lobbying, public relations, and litigation campaigns by Travelers and then-Citicorp, which had announced their merger in April of 1998 (exactly the type of consolidation Congress had intended Glass-Steagall to prevent).[39] For the sake of political convenience and under the guise of financial modernization, Glass-Steagall met its official end.[40]

The enactment of GLBA was a watershed moment in the history of the American financial-services industry.[41] GLBA repealed the provisions of Glass-Steagall prohibiting a bank holding company from engaging in securities underwriting and other non-banking activities and amended the Bank Holding Company Act to allow holding companies to engage

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banking, securities, and insurance industries that the GBLA finally eliminated had, by 1999, become loophole-riddled remnants of their original selves.").

[38] Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999); *see also* CARNELL ET AL., *supra* note 12, at 27 (providing a general discussion of the GLBA).

[39] *See* Walter, *supra* note 30, at 7 ("With the political ducks lined-up for deregulation and the camel"s [sic] nose well under the tent through Section 20 subsidiaries, the merger in April 1998 of Citicorp and Travelers—illegal at the time but permitted under a two-year extendable grace period—simply ignored the remaining functional barriers on the assumption that they would soon be lifted. This bold preemptive strike was soon validated by passage of the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (GLB), and itself may have accelerated the change in regulation."); *see also* Cyrus Sanati, *10 Years Later, Looking at the Repeal of Glass Steagall*, NY TIMES DEALBOOK, Nov. 12, 2009, http://dealbook.blogs.nytimes.com/2009/11/12/10-years-later-looking-at-repeal-of-glass-steagall (referencing the $300 million lobbying effort to repeal Glass-Steagall).

[40] Macey, *supra* note 36, at 715 (discussing the interest group politics involved in the passage of the GLBA).

[41] *Id.*

in activities that are "financial in nature or incidental to such financial activity; or . . . complementary to a financial activity [if it] does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally."[42] "Financial activities" included insurance and securities underwriting, along with others.[43] The Glass-Steagall Act's prohibitions on commercial bank involvement in equity securities and underwriting and on deposit-taking by securities firms were not repealed and remained applicable to financial institutions.[44]

On the passage of the bill, then-Treasury Secretary Lawrence Summers noted, "[t]oday, Congress voted to update the rules that have governed financial services since the Great Depression and replace them with a system for the 21st century. . . . This historic legislation will better enable American companies to compete in the new economy."[45] As one commentator observed, the GLBA lowered the costs of banking—without having to expend resources to find ways around banking regulations (otherwise known as loophole banking), banks were able to achieve increased efficiency in their operations.[46] In fact, the enactment of the GLBA can be traced more to money politics than to a goal of financial

[42] Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338, 1342 (1999).

[43] CARNELL ET AL., *supra* note 12, at 27 (defining financial activities as "underwriting, dealing in, and brokering securities; acting as an investment advisor; merchant banking (i.e., making long-term equity investments for which no public market exists); and underwriting and selling insurance").

[44] *Id.* ("Two vestigal Glass-Steagall prohibitions remained in force. First, a bank—as distinguished from a company affiliated with a bank—can underwrite and deal in only a limited range of securities, such as government securities. 12. U.S.C. §§ 24 (Seventh), 335, 378 (a)(1). Second, the same firm cannot accept both deposits and underwrite securities. Id. § 378(a)(1).").

[45] Sanati, *supra* note 39.

[46] Kane, *supra* note 37, at 5 ("[T]he GLBA may be characterized as lowering and regularizing the cost of circumventing these laws. GLBA removed the need to spend resources on bypassing restrictions on what banks may do and on what kinds of differently chartered (i.e., nonbanking) corporations may own a bank.").

modernization.[47] Regardless, with the demise of Glass-Steagall, banks were free to proceed much as they had before, simply without the pretense of compliance.

D. The Viability of the Financial Supermarket

The repeal of Glass-Steagall brought into question the viability of financial supermarkets—large diversified institutions that began to dominate the banking landscape.[48] The Royal Bank of Scotland in the U.K., UBS in Switzerland, and Citigroup in the United States are prime examples of "financial supermarkets," which, in the wake of GLBA, were able to openly engage in risky trading activities that had severe consequences for taxpayers.[49]

The consolidation of Citigroup provides a good case study. With Commercial Credit as a platform, Sandy Weill, the creator of Citi's financial supermarket, bought Primerica and its Smith Barney brokerage, Travelers insurance, Shearson

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[47] *Id.* at 6 ("The stubborn survival of compartmentalization strategies in the U.S. traced far more to the workings of money politics than to the pursuit of these societywide benefits. The GLBA passed because, as loopholes expanded and proliferated in piecemeal fashion, the political contributions that supported the compartmentalized regulatory regime dwindled and finally fell below the threshold value that opponents were prepared to offer to eliminate what was left of the scheme."); *see also* James Smalhout, *Winners and Losers of the New Finance Law*, EUROMONEY, Dec. 1, 1999, at 68, *available at* http://www.euromoney.com/Article/1005072/Category/0/ChannelPage/0/US-bank-regulation-Winners-and-losers-of-new-finance-law.html (noting that GBLA was the result of struggle between two groups: those willing to pay Congress to leave the restrictions on the financial services industry in place, and those willing to pay Congress to delete the restrictions).

[48] *See generally* Sanati, *supra* note 39.

[49] *See* Holman W. Jenkins, Jr., *Long Live the Financial Supermarket*, WALL ST. J., Jan. 14, 2010, at A11 (defining "financial supermarkets" as "an exercise in horizontal integration that brings together the products and services a consumer would need to manage his financial life" but noting that companies like Citigroup lost track of their ultimate client); *see also* Andy Kessler, *The End of Citi's Financial Supermarket*, WALL ST. J., Jan. 16, 2009, at A11.

(his former brokerage), Aetna, and Salomon Brothers.[50] In 1998, Weill pushed through a $76 billion merger of Travelers with Citibank, notably undeterred by the restrictions of Glass-Steagall (GLBA was passed a year later, legitimizing the merger).[51] With a diminished consideration for risk, the conglomerate then invested in subprime loans packaged into mortgage-backed securities, increased its leverage ratios to 20- or 30-to-1, and kept the borrowing off its balance sheets by using structured investment vehicles ("SIVs").[52] When the SIVs collapsed after short-term financing dried up, Citigroup was forced to recognize the extensive losses on its balance sheets.[53] By early 2009, this collapse forced Citigroup, the recipient of a government bailout, to begin unwinding its supermarket by selling its Smith Barney brokerage to Morgan Stanley.[54]

While financial supermarkets certainly experienced failure, it is important to note that independent banking and brokerage houses did not fare much better.[55] Of the five major independent investment banks that existed in 2008, only Goldman Sachs and Morgan Stanley remain standing, and these two have converted to bank holding companies (allowing better access to short-term funding and potential for deposits).[56] Merrill Lynch and Bear Stearns have both been acquired by deposit-taking institutions, Bank of America and J.P. Morgan, respectively.[57] Lehman collapsed

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[50] Kessler, *supra* note 49.

[51] *Id.*

[52] *Id. See also* CARNELL ET AL., *supra* note 12, at 45 (explaining the concept of leverage, noting that banks' "high leverage and commensurately small equity cushions leave banks vulnerable to business setback such as large, expected loan losses or a sharp increase in interest rates").

[53] Kessler, *supra* note 49.

[54] *Id.*

[55] David Enrich & Damian Paletta, *The Financial Crisis: Walls Come Down, Reviving Fears of a Falling Titan*, WALL ST. J., Sept. 23, 2008, at A6.

[56] Carrick Mollenkamp & Mark Whitehouse, *Old-School Banks Emerge Atop New World of Finance*, WALL ST. J., Sept. 16, 2009, at A1.

[57] *Id.*

in the fall of 2008.[58] As more financial institutions seek to become financial supermarkets, the line between speculative and deposit-taking activity has become increasingly blurred.[59] In fact, the legal barriers between commercial and investment banking have all but disappeared, intensifying debate about the role this distinction's breakdown played in the financial crisis.[60]

In the wake of the economic meltdown, many argue that GLBA and other deregulatory measures were responsible.[61] They note that financially destabilizing practices were led by companies like Citigroup who, with a diminished sense of risk, engaged in questionable financial innovation to maximize profits.[62] The repeal of Glass Steagall, the argument goes, induced banks to become too-big-to-fail, take on unnecessary risk, and cripple the financial system in the process.[63]

III. PROPOSALS FOR FINANCIAL REGULATORY REFORM

In the aftermath of the financial crisis, several academics, politicians, and commentators have called for the resurrection of a Glass-Steagall firewall between deposit-taking institutions and investment banks.[64] One public-

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[58] *Id.*

[59] *See* CARNELL ET AL., *supra* note 12, at 29 ("The blurring of distinctions among financial institutions poses important challenges for the regulatory system. . . . The Gramm-Leach-Bliley Act removed some regulatory distinctions (e.g. by expanding the activities permissible for the affiliates of banks) while reinforcing others . . . .").

[60] *See id.*; *see also* Enrich & Paletta, *supra* note 55.

[61] *See* Enrich & Paletta, *supra* note 55 ("Some politicians and bankers say that Gramm-Leach-Bliley Act . . . and other deregulatory measures set the stage for today's mess."); *see also* Bhide, *supra* note 3; at 31; Roubini, *supra* note 3.

[62] *See* Enrich & Paletta, *supra* note 55.

[63] *Id.*

[64] *See, e.g.*, Roubini, *supra* note 3 (noting that "[a]dvocates of this solution [also] include Paul Volcker (who chaired the Group of Thirty report) and Mervyn King (Governor of the Bank of England)"); *see also* Bhide, *supra* note 3 (calling for a return to simple banking).

policy research organization, in supporting this position, notes that commercial banks were active in buying and selling mortgage-backed securities, credit-default swaps, and other financial derivatives.[65] Its claim, a popular one, is that an uneroded and unrepealed Glass-Steagall would have prevented banks from engaging in most of these activities and rendered the market for such products much smaller, thereby eliminating the need for a bailout.[66] Senator Byron Dorgan, one of the main dissenters of the GLBA at the time of its passage, corroborates this view, noting, "I thought reversing Glass-Steagall would set us up for dramatic failure and that is exactly what has happened . . . to fuse together the investment banking function with the FDIC banking function has proven to be a profound mistake."[67]

This argument has gained traction with many key players in regulatory reform who argue that large commercial banks should be prevented from using the benefit of retail deposit insurance, lender-of-last-resort access, and too-big-to-fail status to engage in other riskier activities.[68] Mervyn King, Governor of the Bank of England, has called for a firm separation of the "public utility" banks from the merchant

[65] Sanati, *supra* note 45 (discussing a report on financial crisis issued by Demos, a non-partisan public policy and research organization).

[66] *Id.*

[67] *Id.*

[68] *See, e.g.*, Willem Buiter, *Too Big to Fail is Too Big,* FIN. TIMES, MAVERECON BLOG, June 24, 2009, http://blogs.ft.com/maverecon/2009/06/too-big-to-fail-is-too-big ("'Public utility banking' with just retail deposits on the liability side and with reserves, sovereign debt instruments and bank loans (secured and unsecured) on the asset side would take care of the retail payment, clearing and settlement system and deposit banking. Such narrow banking would represent an extreme version of Glass-Steagall approach. There would be deposit insurance and, should that fail, a lender of last resort and market maker of last resort. These tightly regulated institutions would not be able to engage in other banking and financial activities, and other financial institutions would not be able to take deposits withdrawable on demand or economically equivalent instruments. . . . Narrow banking or public utility banking would, be a key part of a safer and less morally hazardous banking system.").

banks—a clear return to Glass-Steagall.[69] Paul Volker, former Secretary of the Treasury and one of the most outspoken proponents of the measure, argues for a more moderate view, noting that trading speculation and financial innovation have no place in commercial banking and those that engage in the former should be allowed to fail without impacting the deposit base.[70]

A. A New Glass-Steagall

The arguments in support of resurrecting the Glass-Steagall Act are largely based on moral-hazard grounds.[71] This theory argues that, if large commercial banks enjoy the benefits of retail deposit insurance, lender-of-last-resort access, and too-big-to-fail status, the banks will use these advantages to support proprietary trading activities that create risk for both the institution and the system.[72] In a recent policy brief, Martin Mayer identifies two additional arguments for why the financial crisis demands a new Glass-Steagall.[73] The first is the technical proposition that Glass-Steagall-like firewalls prevent contagion between networks (defined as the various groupings of financial activities which include, for example, commercial and investment

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[69] Mervyn King, Governor, Bank of England, Speech to Scottish Business Orginisations, Edinburgh (Oct. 20, 2009), *available at* http://www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf.

[70] *Volcker Praises the ATM, Blasts Finances Execs, Experts*, WALL ST. J. MARKETBEAT BLOG, Dec. 8, 2009, http://blogs.wsj.com/marketbeat/2009/12/08/volcker-praises-the-atm-blasts-finance-execs-experts/tab/article, (attributing to Paul Volcker the views that "[c]ommercial banks should be tightly regulated as well as protected," and that "[t]rading, speculation and financial innovation should live outside those companies so that if they fail, they fail").

[71] *See* Volcker, *supra* note 4 (discussing how the "the extensive and successful efforts of central banks and governments to rescue large failing and potentially failing financial institutions" has created a "residue of moral hazard").

[72] *Id.*

[73] Martin Mayer, *Glass Steagall in Our Future: How Straight, How Narrow* (Networks Financial Institute Policy Brief 2009-P.B.-07, 2009), 5, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1505488.

banking).[74] Here, the fear is that toxic assets will impact safe deposits without formal separation.[75] If a Glass-Steagall divide were reintroduced, no such contagion would be possible, as a run on one type of institution would not have the cascading effect of causing a run on the other. The second is the psychological concern with mixing the culture of investment banking—where risk taking is the norm—and commercial banking—where prudence is the defining virtue—and still avoiding risky behavior.[76] This view reflects the conception that "modern banking has represented a union between a utility and a casino. What is more, the casino has been wearing the trousers."[77] With the resurrection of Glass-Steagall, such negative cross-cultural influence would cease to be a concern as again, no one financial institution could participate in both activities. Together, these arguments form the drive to implement Glass-Steagall anew.

The proposals to resurrect the Glass-Steagall Act range in severity from limits on commercial-bank involvement in proprietary trading activity, representing narrow

[74] *Id.* ("Glass-Steagall set up firewalls between networks to prevent contagion between them. Repeal of the act in 1999 set the stage for complete network integration and therefore massive contagion.") (quoting ANDREW SHENG, FROM ASIAN TO GLOBAL CRISIS 326 (Cambridge University Press 2009)).

[75] *Id.*

[76] *Id.* ("The third argument is psychological and stresses the basic incompatibility of commercial banking and investment banking. The commercial banker looks at a loan and asks how the borrower is going to repay it, and, if he's any good, he expects a detailed answer; the investment banker looks at a financing and asks how he is going to sell the paper, and he will proceed happily with any plausible answer. In Sheng's more elegant formulation, '[y]ou cannot mix the culture of investment banking (where risk taking is key) and commercial banking (where prudence is vital) under one roof.'") (quoting ANDREW SHENG, FROM ASIAN TO GLOBAL CRISIS 326 (Cambridge University Press 2009))).

[77] ROGER BOOTLE, THE TROUBLE WITH MARKETS: SAVING CAPITALISM FROM ITSELF 214 (Nicholas Brearly Publishing 2009) (attributing the utility/casino expression to British economist John Kay).

interpretations of the Act, to more modified views.[78] In a narrow interpretation of the Act, commercial banking activity is tightly limited to taking deposits and making loans (only simple hedging is permitted).[79] Investment banks, hedge funds, and trusts are free to speculate but are not permitted to trade with or secure credit from regulated banks, with minimal exceptions.[80] This conception represents the simple banking model advocated by some economists.[81]

Under a modified view of the Act, banks that perform classic retail and commercial banking functions are

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[78] *See* Barry Eichengreen, *Out of the Box Thoughts About the International Financial Architecture* 12–13, IMF Working Papers (May 2009), *available at* http://ssrn.com/abstract=1415173.

> Some would go only part way toward the reimposition of Glass-Steagall-style restrictions; UK FSA head Adair Turner, for example, would limit the range of activities that could be undertaken by any one financial institution without necessarily dividing these activities into two (ore more) [sic] mutually-exclusive groups. . . . One conceivable response would be to reimpose Glass-Steagall-like restrictions dividing the banking and financial system into two components. In one component (what we used to call commercial banking) liabilities would be limited to retail deposits, while assets would be limited to low-risk instruments: cash, short-term treasuries, commercial paper, adequately- collateralized small business loans, and conforming mortgages. This would guarantee confidence in the security of deposits, reduce the likelihood of bank runs, and ensure the stability of the payments system. The other component of the system would be allowed to invest in riskier assets. Investment banks would provide loans to sub-investment-grade borrowers and take companies public. Hedge funds and mutual funds would invest in these same entities (both riskier financial and nonfinancial companies) and in their securities.

Id.; *see also* Roubini, *supra* note 3; Bhide, *supra* note 3; Volcker, *supra* note 4; King, *supra* note 69.

[79] *See* Bhide, *supra* note 3, at 31.

[80] *Id.*

[81] *See, e.g.*, *Bhide, supra* note 3 (calling for a return to simple banking).

restricted in their ability to conduct risky trading activity and, as a result, receive the benefit of retail deposit insurance and access to lender-of-last-resort facilities.[82] Banks that are significantly involved in risky trading activities are denied access to these benefits and face market discipline in the event of failure.[83] This is the view championed by Volcker.[84]

Variations on these proposals exist as well. Chief among them are proposals for regulating specific financial activities

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[82] THE TURNER REVIEW, supra note 7, at 94 ("Several commentators have argued for a clear separation of roles in which: [b]anks which perform classic retail and commercial banking functions, and which enjoy the benefits of retail deposit insurance and access to lender of last resort facilities, would be severely restricted in their ability to conduct risky trading activities.").

[83] *Id.* ("Financial institutions which are significantly involved in risky trading activities would be clearly excluded from access to retail deposit insurance and from LOLR facilities, and would therefore face the market discipline of going bankrupt if they ran into difficulties.").

[84] Paul Volcker, *Moral Hazard and the Crisis*, WALL ST. J., June 16, 2009, at A15. In a keynote address to a meeting of the International Institute of Finance in Beijing, June 11, 2009, Volker explained this view:

> One approach would be to set clear policy limits to access the "official safety net." Deposit insurance and central bank liquidity facilities are properly confined to deposit-taking institutions. It is, after all, those institutions that remain the backbone of the financial system. They provide basic essential services, meeting the needs of households, businesses, and other institutions for credit for a safe and liquid repository for their funds, and for both everyday and complex payment services. Historically, the need for continuity in those functions has provided the rationale for close government supervision and protection. In my view, it is unwarranted that those same institutions, funded in substantial part by taxpayer-protected deposits, are engaged in substantial risk-prime proprietary trading and speculative activities that may also raise questions of virtually unmanageable conflicts of interest.

Id.

(without a clear divide) and for size restrictions (which would lead to fewer systemic institutions).[85]

B. The Glass-Steagall Fallacy

There are several arguments against such proposals, the foremost being that the repeal of Glass-Steagall played only a limited role in creating the financial crisis.[86] As a report on the causes of the financial crisis by the American Bar Association ("ABA") concludes, GLBA was not responsible for risks undertaken by banks or their affiliates:

> The most elemental causes of the financial crisis had nothing to do with securities brokerage or underwriting and dealing, or insurance activities. Rather, they signal a failure in the most basic of banking functions—lending and credit underwriting. The securitization of loans was not an activity prohibited by the Glass-Steagall Act.[87]

The ABA report finds that weak underwriting standards and flawed risk assessment contributed to the banking

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[85] Walter, *supra* note 30, at 31 ("A less draconian approach to reinstatement of activity separation along the lines of Glass-Steagall involves recognition that some types of financial activities should not be allowed within multifunctional financial firms deemed to be systemic and having powerful public utility characteristics. . . . An alternative to carve-outs is to limit the size of financial conglomerates that incorporate commercial banking units, so that they are forced to become non-systemic. Metrics to achieve this could include market share caps, deposit or asset ceilings, and the like. This would not involve activity prohibitions, but size-constrained financial conglomerates would soon lose critical mass in specific areas of engagement, and presumably would try to focus on the most profitable ones and divest others.").

[86] *See generally* Peter J. Wallison, *Did the 'Repeal' of Glass-Steagall Have Any Role in the Financial Crisis? Not Guilty. Not Even Close,* 1 (Networks Financial Institute, Policy Brief 2009-PB-09, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1507803.

[87] CAUSES AND CONTRIBUTING CIRCUMSTANCES, *supra* note 7, at 32 (finding that the GLBA was not responsible for unsound and risky practices at banks or their affiliates).

crisis.[88] In an article discussing regulation-induced innovation, Edward Kane corroborates this view, noting that the financial crisis was mainly the result of poor regulatory oversight and reduced private-sector discipline. [89] While the GLBA certainly made it easier for institutions to reach too-big-to-fail status, it was not responsible for causing a collapse in due-diligence incentives or over-leveraging by leading borrowers and lenders."[90]

Moreover, it is notable that the GLBA repealed only the affiliation provisions of Glass-Steagall, which had already been significantly eroded; it did not permit banks to engage in any previously prohibited activities.[91] Even under Glass-Steagall, banks could purchase and sell securities or whole loans as well as securities based on assets (such as mortgages).[92] The GLBA only permitted banks to be affiliated with firms that engaged in underwriting or dealing in securities through a subsidiary of a bank's holding

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[88] *Id.* at 6–10 ("The most central cause of the crisis was the making of too many mortgages to too many borrowers based on flawed credit underwriting standards and unrealistic assumptions about the likelihood of repayment and rising home values. . . . In the current crisis, nonbank participants in the mortgage markets played a key role in causing the crisis . . . The new [lending] model was based on the securitization of loans. Securitization developed as a means by which banks could transfer loans and other assets off their balance sheets to trusts or other vehicles which then issued units of interest or "securities" to investors. That way, banks freed up their capital for more loans and assets. Securitization essentially transferred the risk of mortgage lending from banks to investors.").

[89] Kane, supra note 37, at 3 ("The financial crisis of 2007–09 is the product of a regulation-induced shortcutting and near elimination of private counter-party incentives to perform adequate due diligence along the chain of transactions traversed in securitizing and re-securitizing risky loans. The GLBA did reduce the costs of regulatory shopping and make it easier for institutions to make themselves more difficult to fail and unwind. But it did not cause due-diligence incentives to break down in securitization and lending, nor did it cause borrowers and lenders to over leverage themselves.").

[90] *Id.*

[91] *See* Wallison, *supra* note 86, at 7.

[92] *Id.* at 6.

company or through a subsidiary of the bank itself.[93] In fact, Glass-Steagall continues to prevent banks from "underwriting or dealing" in securities themselves.[94]

Additionally, it is clear that narrow[95] banking is not immune from risk. For example, Northern Rock and Washington Mutual were "narrow banks" that focused almost entirely on classic commercial banking activities and suffered catastrophic failures in the aftermath of the financial crisis.[96] Standalone investment banks also failed with rippling effects on global finance.[97] In fact, among the hardest-hit institutions were Bear Stearns and Lehman Brothers,[98] pure investment banks that had ventured into mortgage lending—something that would not necessarily have been prohibited even under Glass-Steagall.[99]

In fact, the GLBA may have helped stabilize the financial industry in the wake of the crisis.[100] Without Glass-Steagall, J.P. Morgan Chase could not have rescued Bear Stearns and Bank of America could not have saved Merrill Lynch.[101] Some commentators go further to argue that this integrated model actually makes more sense:

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[93] *Id.* at 6.

[94] *See* 12 U.S.C. § 24 (Seventh) (2008); 12 U.S.C. § 378 (2010).

[95] *See* King, *supra* note 69 (defining "narrow" banking as banking that "separate[s] totally the provision of payments services from the creation of risky assets").

[96] *See* TURNER REVIEW, *supra* note 7, at 95 ("[I]t is important to recognize that 'narrow banks' focusing almost entirely on classic commercial and retail banking activities can be extremely risky. Northern Rock, Washington Mutual and IndyMac were all 'narrow banks.'").

[97] Alison Vekshin & James Sterngold, *Reviving Glass-Steagall Means Escalating 'War' on Wall Street,* BLOOMBERG, Dec. 28, 2009, http://www.businessweek.com/news/2009-12-28/reviving-glass-steagall-means-escalating-war-on-wall-street.html.

[98] *Id.*

[99] Robert Pozen, *Stop Pining for Glass-Steagall,* FORBES, Oct. 5, 2009, at 24, *available at* http://www.forbes.com/forbes/2009/1005/opinions-glass-steagall-on-my-mind.html.

[100] *See* Calomiris, *supra* note 8.

[101] *Id.*

> [T]he collapses this year of Bear Stearns and Lehman Brothers Holdings Inc. were fueled largely by the evaporation of liquidity—the cash the firms relied on to finance their day-to-day operations. If Bear and Lehman had access to deep pools of deposits, it would have provided them with a steady source of low-cost financing that protected them when the credit markets seized up last year. That was the impetus for Merrill Lynch agreeing to sell itself to Bank of America Corp., the nation's largest retail bank, and for Goldman and Morgan Stanley deciding . . . to register as bank holding companies that are allowed to collect deposits from retail customers.[102]

The consolidation could indicate a change to a more efficient business model for financial institutions, which would have been impossible without the GLBA.

The larger point, however, is that whatever the role of the GLBA in the lead-up to the financial crisis, the imposition of a complete institutional separation of utility banks from investment banks appears impractical in the modern economic climate.[103] Even key proponents of Glass-Steagall reform note that "trading activities which produced losses differ only in scale and motivation" from the activities that a commercial bank might have undertaken without the GLBA. In fact, they concede that the distinction between commercial and proprietary activity "may be cloudy at the border."[104]

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[102] Enrich & Paletta, *supra* note 55.

[103] TURNER REVIEW, *supra* note 7, at 95; *see also* Buiter, *supra* note 68 (conceding that "[f]or the time being, banks that are too big, too interconnected, too complex or too international to fail are bound to be with us").

[104] Adair Turner, Chairman, Fin. Serv. Auth. (U.K.), Speech at Turner Review Conference: Progress Towards Global Regulatory Reform (November 2, 2009), *available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/1102_at.shtml ("John Kay, who has pointed out that 'the trading activities which produced losses differ only in scale and motivation not inherent nature from the treasury activities which a commercial bank might properly undertake in its normal day-to-day business' and Paul Volcker, while frequently quoted as the key proponent of the new Glass Steagall approach comments that 'some trading, it is

These boundaries have been further blurred by the Bear Stearns and Merril Lynch takeovers discussed above.[105] Dividing proprietary and customer-related activity would require regulators to draw arbitrary lines between what should and should not be protected, raising questions as to the viability of such an approach.[106]

Moreover, competing in the global economy may require large-scale financial institutions.[107] It would be difficult for any one country to pursue such a separation without the cooperation of other countries—a highly unlikely outcome.[108] It is unclear whether narrow banking is even practical in the modern global economy, or that it could play a role in reducing systemic financial risk.[109]

It follows that proposals to reinstate Glass-Steagall have gained little momentum, either in the United States or abroad.[110] One Obama appointee noted that the concept of breaking up big banks was "more a provocative idea than a

reasonably argued, is necessary as part of a full service customer relationship', and that the distinction between proprietary and customer related activity 'may be cloudy at the border.'").

[105] *See* Calomiris, *supra* note 8.

[106] *See id.*

[107] *See* TURNER REVIEW, *supra* note 7, at 94 ("[I]t would be difficult for any one country to pursue a clear separation while other countries did not, particularly within the European Union, and there is unlikely to be an agreement on an appropriate division, given the very different historic traditions. And it is not clear that in its extreme and simple form, it is practical in today's complex global economy, or that it would radically reduce banking system risks.").

[108] *Id.*; *see also* Eichengreen, *supra* note 78, at 13 ("In a financially integrated world such reforms will be feasible only if coordinated internationally. Otherwise, Icelandic banks will be allowed to take deposits from British savers and invest them in risky assets. British banks will complain that they are unable to compete, given harsh restrictions on their funding and investments, if foreign banks are free of such restrictions. To be both effective and politically acceptable, a new Glass-Steagall Act would have to be coordinated internationally.").

[109] TURNER REVIEW, *supra* note 7, at 94.

[110] *See id.*

proposal."[111] Federal Reserve Chairman Ben Bernanke has said he would prefer a "more subtle approach without losing the economic benefit of multifunction, international firms."[112] In fact, it remains uncertain whether industry and regulatory interests can be aligned to achieve even basic banking reforms, let alone a return to the unpopular restrictions of Glass-Steagall.[113] Nevertheless, current proposals to regulate financial institutions take elements of the Act into account in varying degrees.[114]

C. Proposals for Financial Regulation

The proposals on the floor of the U.S. House of Representatives and Senate at the time of this writing, along with those suggested by international bodies and the Obama administration, aim to address the problem of too-big-to-fail financial institutions through new prudential standards.[115] While strong opportunities for reform exist, it is yet unclear how the debates will play out.

1. The Group of Thirty Report

In January 2009, the Group of Thirty, a private, nonprofit, international body, released a report focused on financial regulatory reform. The report identified a need for comprehensive changes that address institutional, market, regulatory, policy, and infrastructural weaknesses in the international financial framework as well as gaps in regulatory oversight, accounting and risk-management

[111] Stephen Labaton, *Trying to Rein In 'Too Big to Fail' Institutions*, N.Y. TIMES, Oct. 25, 2009, at A1 (quoting Daniel K. Tarullo, whom President Obama appointed to the Federal Reserve Board of Governors).

[112] *Id.*

[113] *See infra* Part III.C.1.

[114] *See infra* Part III.C.

[115] *See, e.g.*, *id.* at 7.

practices.[116] The Group of Thirty Report presented four core recommendations:

> (1) eliminate gaps and weaknesses in the coverage of prudential regulation and supervision and subject all systemically significant financial institutions, regardless of type, to an appropriate degree of prudential oversight;
> (2) improve the quality and effectiveness of prudential regulation and supervision, with higher levels of national and international policy coordination;
> (3) strengthen institutional policies and standards, with particular emphasis on standards for governance, risk management, capital, and liquidity, including regulatory policies and accounting standards that guard against procyclical effects;
> (4) increase transparency of financial markets and products, with better aligned risk and prudential incentives and more robust supporting infrastructure that is resistant to potential failures of even large financial institutions.[117]

While a specific recommendation called for the increased separation of deposit-taking institutions from unregulated affiliates and high-risk activities, the report did not go as far as to call for a resurrection of the Glass-Steagall divide.[118]

2. The U.S. Treasury Proposal

Of the proposals under discussion over the last year, the first U.S. Treasury proposal was perhaps the furthest from implementing Glass-Steagall-like limitations, with no

[116] *See generally* GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY (2009), *available at* http://www.group30.org/pubs/reformreport.pdf.

[117] HISTORY AND BACKGROUND OF PREVIOUS REGULATORY REFORM PROPOSALS, *supra note* 29, at 47–48 (summarizing the Group of Thirty Report).

[118] *Id.* at 48.

mention of reinstating the Act's firewalls.[119] The Treasury proposal had five key principles: (1) ensure "robust supervision of financial institutions"; (2) "establish comprehensive regulation of financial markets"; (3) "protect consumers and investors from financial abuse"; (4) "provide the government with tools to manage the financial crisis"; and (5) work towards "international regulatory standards and cooperation."[120] The proposal would designate institutions as too-big-to-fail, subject them to greater capital requirements and limits on risk-taking, and mandate the creation of living wills.[121] Living wills are defined as proposals, drafted by the institutions themselves, detailing how they would wind down their activities in event of failure—creating market discipline with a dissolution process controlled by the government instead of creditors.[122] Furthermore, the proposal would concentrate authority in the Federal Reserve to create a special regulatory regime, including requirements for capital, leverage, and liquidity for any firm "whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed," along with power given to the Treasury to appoint a conservator to stabilize a failing firm in lieu of bankruptcy.[123]

The Glass-Steagall school argues that the problem with this approach is that it signals to markets that banks can be too-big-to-fail, creating a moral hazard issue in which all institutions seek such too-big-to-fail status in order to have systemic risk protection.[124] Peter Wallison, for example,

[119] *See generally* U.S. DEPARTMENT OF THE TREASURY, FINANCIAL REGULATORY REFORM—A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATIONS (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

[120] *Id.* at 1.

[121] *Id.* at 10–18.

[122] *Id.*

[123] *Id.* at 10 (stating that a firm subject to such regulations would be identified as a Tier 1 financial holding company ("FHC")).

[124] Peter Wallison, *Too Big to Fail, or Succeed*, WALL ST. J., June 18, 2009, at A17.

argues that this would have a significant negative impact on competition and decries the Obama administration's proposals as raising antitrust concerns.[125] However, the capital and liquidity requirements emphasized in the Treasury concept, combined with increased focus on the creation of corporate living wills, one of the most overlooked aspects of the proposal and of financial reform generally, may be one of the most viable mechanisms for regulating banking behavior.

3. The Financial Stability Improvement Act

On October 27, 2009, The House Financial Service Committee introduced the Financial Stability Improvement Act ("FSIA"), designed to give broad supervisory powers over institutions designated as systematically important to the Federal Reserve.[126] The proposed powers included the authority to mandate higher risk-based capital requirements, leverage limits, liquidity rules, concentration limits, living wills, and the power to sell and transfer assets, terminate activities, and impose conditions on business activities.[127] The Kanjorski amendment to the FSIA went further to propose a number of criteria to determine when banks need to be broken up, including "scope, nature, size, scale, concentration, and interconnectedness of financial companies."[128]

The bill, which eventually passed in December 2009, largely adopts the GLBA view, modified to address systemic risk, and is closely aligned with the reforms initially proposed by the U.S. Treasury (and supported by the Turner Review in the U.K. and academic advisory groups including

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[125] *Id.*

[126] *See generally* Financial Stability Improvement Act, H.R. Discussion Draft, 111th Cong. (2009), *available at* http://www.house.gov/apps/list/press/financialsvcs_dem/title_i_discussion_draft_final.pdf.

[127] *Id.* at 18.

[128] Amendment to the Committee Print of Oct. 29, 2009, H.R. Discussion Draft, 111th Cong. (2009), 2, *available at* http://kanjorski.house.gov/images/stories/09_11_18%20tbtf%20amendment%20text.pdf.

CEPR/Geneva and de Larosiere).[129] It suggests that the degree of complexity and interconnectedness within the activities of financial supermarkets is a greater concern than sheer size.[130] To address this, the bill focuses on regulating large banks through fees, capital requirements, and potential limits on activities with the option to separate banking and investment operations if concerns regarding an institution's stability arise.[131]

While the bill preserves many of the most viable measures for regulating banking operations, the problem with overreliance on a metric such as leverage limits remains.[132] Consider the following example:

> Take two companies, both with $100 million of equity, one with a billion dollars of Treasuries, levered 10 times, and one with $500 million of illiquid Eastern European debt. One is levered 10 times; one levered five times. Which is a more secure company: one that you can liquidate in 30 seconds and have all cash, or one that you can't liquidate under any circumstances? So looking at leverage as a broad-brush measure is really, really a deceiving measure.[133]

In this situation, a leverage limit artificially penalizes the former company when it is in fact the latter that is of greater concern.[134]

Additionally, a look at the Canadian system illustrates this point. Proponents of stricter regulations on leverage

[129] *See* H.R. 4173, 111th Cong. (2009), *available at* http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/hr4173eh.pdf; *see also* Roubini *supra* note 3 (citing support from academic advisory groups); *see also* Carl Hulse, *House Approves Tougher Rules on Wall Street,* N.Y. TIMES, Dec. 11, 2009, at A1.

[130] *See* H.R. 4173, 111th Cong. (2009), at 114.

[131] *Id.* at 59–60, 325.

[132] Nikhil Deogun, *Is Wall Street Over?*, WALL ST. J., Mar. 30, 2009, at R4 (quoting Gary Cohn, president of Goldman Sachs Group, Inc., as describing the concept of leverage as "misunderstood" and "deceiving").

[133] *Id.* (quoting Gary Cohn, president of Goldman Sachs Group, Inc.).

[134] *Id.*

and capital ratios attribute the strong performance of the Canadian banks to such measures.[135] However, it is important to note the striking differences between the U.S. and Canadian systems and approaches before exclusively relying upon such methods to effect safer banking practices (compare for instance affordable housing policies and availability of non-recourse loans).[136] Tighter leverage limits in Canada likely reduced incentives for banks to pursue securitization.[137] However, even with lower average leverage ratios, Canadian banks would not have fared so well had they not disposed of toxic assets well before the financial crisis.[138] No regulation mandated such risk-evaluating

[135] Marie-Josee Kravis, *Regulation Didn't Save Canada's Banks*, WALL ST. J., May 7, 2009, at A17 ("Advocates of increased regulation of U.S. financial markets have concluded that more stringent rules governing leverage and capital ratios account for Canada's impressive performance. They champion such measures here.").

[136] *Id.* ("Canadian banks are not compelled by laws such as our Community Reinvestment Act to lend to less creditworthy borrowers. Nor does Canada have agencies like Fannie Mae and Freddie Mac promoting 'affordable housing' through guarantees or purchases of high-risk and securitized loans. . . . A homeowner in the U.S. can simply walk away from his loan if the balance on his mortgage exceeds the value of his house. The lender has no recourse except to take the house in satisfaction of the debt. Canadian mortgage holders are held strictly responsible for their home loans and banks can launch claims against their other assets.").

[137] *Id.* ("Tighter leverage limits in Canada may have dimmed the incentives for its banks to pursue securitization as brashly as their American counterparts. But regulations cannot take all the credit."). *But see* Theresa Tedesco, *The Great Solvent North*, N.Y. TIMES, Feb. 27, 2009, at A23 (arguing that Canada is a model the United States should emulate but noting that "Canadian banks are known to be risk-averse, and this has served them well. While their American counterparts were loading up their books with risky mortgages, Canadian banks maintained their lending requirements, largely avoiding subprime mortgages. The buttoned-down banks in Canada also tended to keep these types of securities on their books, rather than packaging them and selling them to investors.").

[138] Kravis, *supra* note 135 ("Even with leverage ratios held on average at 18 to 1 (versus 26 to 1 for U.S. commercial banks and up to 40 to 1 for U.S. investment banks), Canadian banks would not be as healthy as they

behavior.[139] That said, even those who claim that Glass-Steagall can do what capital and leverage limits cannot should make note of the fact that Canada repealed its version of the act in 1987.[140]

4. The "Restoring American Financial Stability Act of 2009"

The Senate Banking Committee also introduced a version of the House bill, the Restoring American Financial Stability Act of 2009, calling for higher capital requirements on large and interconnected firms without going so far as to propose a dissolution mechanism to break up too-big-to-fail institutions when they reach a certain size or scope.[141] The most significant difference between the Senate and House proposals is the call to merge the banking regulators set up in the 1930s, which had separate jurisdictions based in part on the Glass-Steagall divisions, into a single agency.[142]

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are had they not disposed of their more problematic securitized assets four to five years ago.").

[139] *Id.*; *see also* Tedesco, *supra* note 137 ("Canadian banks are known to be risk-averse, and this has served them well.").

[140] Kravis, *supra* note 135, ("Those who blame financial deregulation for the breakdown of U.S. markets should note that Canada shed its version of Glass-Steagall more than 20 years ago."). *But see* Tedesco, *supra* note 137 ("Since Canada's financial services sector was deregulated in 1987, permitting the banks to buy brokerage houses, they have enjoyed vast earnings power because of their diverse businesses and operations.").

[141] *See generally* Restoring American Financial Stability Act of 2009, S. Discussion Draft, 111th Cong. (2009) *available at* http://banking.senate.gov/public/_files/AYO09D44_xml.pdf; Editorial, *Another Round of Regulatory Reform,* N.Y. TIMES, Nov. 18, 2009, at A34 (observing that "the Dodd plan imposes costs—like higher capital requirements—on large and interconnected firms. The aim is to make size and complexity so costly that firms opt to be smaller. The plan stops short, however, of creating a fail-safe mechanism to break up too-big-to-fail firms—before they fail—if incentives to downsize don't work").

[142] *See* Editorial, *supra* note 141 ("The House and administration would distribute supervisory powers among the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency. Mr. Dodd calls for the creation of one main federal regulator, reasoning that a single regulator would end 'regulator

Whereas the House and the Treasury would distribute supervisory powers among the Federal Reserve, the FDIC, and the Office of the Comptroller of the Currency, the Senate effort, led by Senator Christopher Dodd (D-CT), would create one main federal regulator to prevent "regulator shopping."[143] The proposal faces great opposition from Republican Party members who are averse to the idea of a new regulatory agency as a solution to these problems.[144] As a result, the bill stalled in late 2009.[145]

5. The Banking Integrity Act of 2009

The Banking Integrity Act of 2009, introduced in December 2009 by Senators John McCain (R-AZ) and Maria Cantwell (D-WA), is the only proposal to directly call for the return of Glass-Steagall: a clear separation of commercial banks from investment banks.[146] Under the proposed legislation, financial firms operating commercial banks and investment brokerages would have to decide whether to continue their commercial banking activity or to become an investment bank within a year of the bill's enactment.[147] Cantwell argues that the bill restores safeguards to deposit

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shopping'—whereby banks choose their own overseer, invariably opting for the weakest one.").

[143] *Id.*

[144] *See* Michael R. Crittenden, *Bipartisan Duo Moves Ahead on Finance Bill,* WALL ST. J., Dec. 24, 2009, at A2 (discussing how differences between Democrats and Republicans over the goal of banking regulation have impeded progress).

[145] *Id.*

[146] *See* Banking Integrity Act of 2009, S. Discussion Draft, 111th Cong. (2009), *available at* http://www.demos.org/pubs/bankingintegrityact_09.pdf; *see also* Damian Paletta, *Bank Lobbyists Get Lump of Coal as Senators Call for Reinstated Glass-Steagall,* WALL ST. J. REAL TIME ECONOMICS BLOG Dec. 16, 2009, http://blogs.wsj.com/economics/2009/12/16/bank-lobbyists-get-lump-of-coal-as-senators-call-for-reinstated-glass-steagall/tab/article; Alison Vekshin, *U.S. Senators Propose Reinstating Glass-Steagall Act,* BLOOMBERG, Dec. 16, 2009, http://www.bloomberg.com/apps/news?pid=20601103&sid=aQfRyxBZs5uc.

[147] *See* Paletta, *supra* note 146; Vekshin, *supra* note 146.

money by preventing exposure to speculative activity.[148] While the bill gained some legitimacy when Representative Maurice Hinchey (D-NY) introduced a version in the House, the political infeasibility of its passage was highlighted when a top banking expert called it "crazy" in the aftermath of the consolidations resulting from the financial crisis.[149] The bill would require J.P. Morgan to give up the Bear Stearns trading operations and separate from Chase, and require Bank of America to give up Merrill Lynch.[150] While discussion is expected to continue, passage appears highly unlikely.

6. The "Volcker Rule"

The most recent proposal, "the Volcker Rule" presented by President Obama, would seek to prevent commercial banks from engaging in proprietary trading and would limit their overall size.[151] FDIC-insured banks would be

[148] Press Release, Maria Cantwell, Cantwell, McCain Bill Returns Stability and Security to Commercial Banking (Dec. 16, 2009), *available at* http://cantwell.senate.gov/news/record.cfm?id=320823.

[149] Vekshin, *supra* note 146 ("'Trying to split them up is crazy,' John Douglas, a former general counsel at the Federal Deposit Insurance Corp. who leads the bank regulatory practice at Davis Polk & Wardwell LLP in New York, said in a telephone interview. 'The integration of the securities and banking function came about because of the need of large corporate customers to have integrated banking and securities services.'"). Others corroborated this view. *See, e.g.*, Vekshin & Sterngold, *supra* note 97 ("'If you look at what happened, with or without Glass-Steagall, it would have made no difference,' said H. Rodgin Cohen, chairman of New York-based law firm Sullivan & Cromwell LLP. . . . Rather than split up banks, regulators should provide better supervision and require tougher capital requirements, said Cohen. . . . [Senator Christopher] Dodd [also] said he doesn't favor reviving Glass-Steagall as a way of dealing with 'too-big-to-fail' institutions and added 'there are other things we can do to break them up.'").

[150] Vekshin, *supra* note 146.

[151] *See generally* "Volcker Rule Proposal," *available at* http://graphics8.nytimes.com/packages/images/nytint/docs/amendments-to-the-bank-holding-company-act/original.pdf; *see also* Editorial, *Glass-Steagall Lite,* ECONOMIST ONLINE, Jan. 22, 2010, http://www.economist.com/opinion/displayStory.cfm?story_id=15374543&source=features_box1

prohibited from investing in private-equity or hedge funds or from engaging in speculative activities for their own accounts.[152] They would, however, be able to continue underwriting securities and providing investment advice to clients.[153]

The proposal, which would establish some semblance of the Glass-Steagall divide, has been met with great resistance from both legislators and bankers.[154] Members of the Senate Banking Committee note that the proposal may be significantly modified before going into effect which could strip it of its ability to address risk-taking behavior (or conversely, could strengthen it to look more Glass-Steagall).[155] Bankers are simultaneously arguing that proprietary activity makes up an insignificant percentage of

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("Though not a full return to Glass-Steagall . . . it is at least a return to its 'spirit.' . . . The first half of the plan concerns restrictions on the scope of activities. Banks that have insured deposits, and thus access to emergency funds from the central bank, would not be allowed to own or invest in private equity or hedge funds. Nor would they be able to engage in 'proprietary' trading—punting their own capital—though they could continue to offer investment banking for clients, such as underwriting securities, making markets and advising on mergers. The second part focuses on size. Banks already face a 10% cap on national market share of deposits. This would be updated to include other liabilities, namely wholesale funding.").

[152] *Id.* Debate on the details of the proposal were ongoing at the time of this writing.

[153] *Id.*

[154] Damian Paletta, *'Volcker Rule' Stalls in Senate,* WALL ST. J., Feb. 24, 2010, at A4 (noting that "[k]ey senators are expected to scrap President Barack Obama's proposal to prohibit commercial banks from certain risky trading activities, people familiar with the matter said, a setback for the administration's bid to limit the size and scope of the largest U.S. banks. . . . The White House introduced the Volcker rule in January as part of its broader proposal to overhaul financial regulations in the wake of the financial crisis, but that package is now being dialed back by lawmakers.").

[155] Cyrus Sanati, *Yearning for Glass-Steagall on Capitol Hill,* N.Y. TIMES DEALBOOK, Jan. 22, 2010, http://dealbook.blogs.nytimes.com/2010/01/22/yearning-for-glass-steagall-on-capitol-hill ("[D]ebate in the House and Senate committees could water down the bill's impact on the banks, but it could also toughen the bill up to look a bit more like Glass-Steagall.").

their overall business, that mandating a separation would entail drawing arbitrary lines between banking activities, and that banks would simply engage in arbitrage around the regulation if it were to go into effect.[156] These considerations speak to both the impracticality of such a rule and the difficulty of enforcement—a more detailed plan may be required before the proposal finds its way into legislation.[157]

IV. LIVING WILLS AND A NEW GLASS-STEAGALL?

While the focus on capital and liquidity requirements forms the crux of the Treasury's original proposal, perhaps most interesting is the concept of living wills, which would require systemically important banks to develop dissolution plans in the event of a crisis.[158] While the concept is too new to have yet generated significant published academic

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[156] *See* Andrew Ross Sorkin, *Bankers in Davos Seek Unity*, N.Y. TIMES, Feb. 2, 2010, at B1 ("A senior banker put it to me more bluntly: 'I can find a way to say that virtually any trade we make is somehow related to serving one of our clients. They can go ahead and impose the rule on Friday, and I can assure you that by Monday, we'll find a way around it. Nothing will change unless the definition is ironclad.' Indeed, in the past week and half, banks have tried to estimate their proprietary trading, with most banks suggesting that it is a minuscule part of their business. JPMorgan Chase, Morgan Stanley and others estimated it at less than 2 percent of their business; Goldman Sachs said it was under 10 percent.").

[157] *See Glass-Steagall Lite, supra* note 151 ("With details yet to be hammered out, the plan's effects are hard to gauge. . . . Enforcement could be tricky, too. Regulators will struggle to differentiate between proprietary trades and those for clients (someone is on the other side of every trade) or hedging. Getting it wrong would be counter-productive: preventing banks from hedging their risks would make them less stable."); *see also* Paletta, *supra* note 154 ("[F]ew people now expect the concept to be included in the financial-overhaul legislation, in large part because the White House hasn't spelled out to Congress exactly how a ban on proprietary trading would work . . . .").

[158] *See* Willem Buiter, *Forget Tobin Tax: There is a Better Way to Curb Finance*, FIN. TIMES, Sept. 1, 2009, at 9 ("A regularly updated 'will' for each systemically important financial institution would eliminate any remaining 'too big, too interconnected, too complex and too international to fail' obstacles to the Darwinian discipline of the market, which has been sorely missed in the financial sector.").

commentary, living wills would minimize systemic risk by providing central banks with a plan for supporting or abandoning problem institutions, limiting the spread of contagion.[159] For living wills to effectively police future bank failures, however, they must force banks to simplify their internal organizational structures such that they ring-fence higher-risk operations from lower-risk ones.[160] Ring-fencing in this context would involve the legal separation of certain assets or liabilities, creating a financial architecture focused on safety and soundness instead of regulatory and tax arbitrage.[161] If these requirements were sufficiently

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159 *Death Warmed Up, supra* note 11. ; *see also* Buiter, *supra* note 68 ("I would support a proposal made by Raghuram Rajan and by Richard Herring, that such institutions be required to develop a bankruptcy contingency plan that would lay out how they would resolve themselves quickly and efficiently. Such a 'shelf bankruptcy' plan would require banks to track and document their exposures much more carefully than they do now and in a timely manner. An insolvency plan is just as vital as a business plan for a financial institution in the too big to fail category. As Governor Mervyn King said in his 2009 Mansion House speech: everyone should have a will, including banks.").

160 *Death Warmed Up, supra* note 11. Simplifying organizational structures would render more transparent the interconneteness of banking activity, a key goal for regulatory reform. *See* Walter, *supra* note 30, at 27 ("The complexity of the financial services industry as a whole and individual financial intermediaries themselves has important and unique implications for the nature and effectiveness of regulation.").

161 Tom Braithwaite, Patrick Jenkins & Brooke Masters, *Turner Backs Banks' Living Wills*, FINANCIAL TIMES, Sept. 3, 2009, at 1 (quoting Lord Adair Turner, Chairman of the U.K. Financial Services Authority as noting "[l]iving wills will be a forcing device for the clarification and simplification of legal structures. . . . In the past, authorities around the world have tended to be tolerant of the proliferation of complex legal structures designed to maximise regulatory and tax arbitrage. Now we may have to demand clarity of legal structure."). In an article on the effects of internal organizational structure on conflict-of-interest problems in securities underwriting, Randall Kroszner and Raghuram Rajan note the value of internal divisions for self-monitoring: "The internal divisions and independent monitors could raise the costs (hence reduce the likelihood) of future opportunistic behavior. Internal structure thus could be a means by which the management of an enterprise binds its hands, and commits to a particular quality and reliability of business practices." Randall S. Kroszner and Raghuram G. Rajan, Organization Structure and

demanding, they would in effect result in Glass-Steagall-like barriers within financial institutions, imposed by the institutions themselves.[162] Although banks would certainly be allowed to carry out both investment banking and depository functions, these activities would be structured in a way to prevent failure in one sector from spreading to the other.[163] Moreover, in creating a simplified organizational framework through planning for their own demise,[164] banks may choose to downsize voluntarily when diversification no longer appears efficient, thereby addressing Glass-Steagall concerns.

The idea of a living will raises two central legal policy questions beyond the economic consideration of what activities should be protected: (1) How can legal structures

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Credibility: Evidence from Commercial Bank Securities Activities Before the Glass-Steagall Act, 3 (March 1997), *available at* http://ssrn.com/abstract=45322. Ring fencing in the banking context could similarly bind the hands of management in the interest of safety and soundness. Moreover:

> [I]f banks were run as federations of self-contained units, it would be easier to swoop in and save some parts while allowing others to die. For a unit to be safe, though, it would have to have not just its own capital, but its own funding and minimal counterparty exposure to other bits of the group.

Death Warmed Up, supra note 11.

[162] *See Death Warmed Up, supra* note 11. The requirements for what constitutes an effective living will vary based upon the determination of what assets should be protected, a topic outside of the purview of this Note.

[163] *Id.*

[164] *Id.*; Gillian Tett, *Idea of 'Living Wills' is Likely to Die Quiet Death,* FIN. TIMES, Aug. 14, 2009, at 18, *available at* http://www.ft.com/cms/s/0/098ac1ec-882d-11de-82e4-00144feabdc0.html ("The issue at stake revolves around a matter that often bedevils personal wills—namely, the tricky question of transparency. In order to make it easy to wind down a large bank, it is crucial to have structures that are relatively simple and streamlined. However, in the past few decades, the largest banks in the world have stealthily built corporate structures that are fiendishly complex, straddling numerous borders and plagued with offshore entities. Lehman Brothers was but one example of that.")

be simplified to allow ring-fencing, and (2) what are the ramifications for financial institutions? Both questions demand an analysis of the organization of banking operations.

A. Ring-Fencing and Living Wills

Regulation of banks should look to economic substance not legal forms.[165] As one observer notes, "if the economic function of the instrument is insurance, banks should be kept off the playing field. If the trading activity involves the pledging of liability structures that include insured deposits, the bank should be barred access to the trading room."[166] Banks can be organized along geographic as well as product lines to prevent contagion from toxic assets.[167] In either case, by engaging in the ring-fencing project (in support of a living will), financial institutions would be required to simplify their internal legal structures,[168] accounting for individual efficiencies while guarding against the contagion of potentially risky activities.[169]

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[165] Adair Turner, Chairman, Fin. Serv. Auth. (U.K.), The Economist's Inaugural City Lecture (Jan. 21, 2009), *available at* http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0121_at.shtml.

[166] *See* Mayer, *supra* note 73, at 14 (expanding upon Lord Turner's position).

[167] *See Death Warmed Up*, *supra* note 11. One option is to force banks to organize into self-contained national subsidiaries (an example is HSBC, whose major subsidiaries are all incorporated entities with their own capital bases and balance sheets). *Id.*

[168] *See* Tett, *supra* note 164 ("[Living wills] would in essence force banks to stipulate in advance how their operations could be wound down in a crisis and how their assets might be distributed, in the hope that such clarity might help to avoid a replay of the type of panic that erupted when Lehman Brothers collapsed last autumn. What spooked regulators and investors at the end of last year was not just the bank's collapse, but the fact that it was unclear where Lehman's assets lay, or who could claim them. Thus, by injecting more transparency—and forethought—into corporate structures, another panic might be averted . . . .").

[169] *See* Santos, *supra* note 27, at 112 ("Were it not for the distortions arising from the safety net, in a competitive market a bank would choose the most appropriate conglomerate model to integrate traditional commercial banking activities with securities services by comparing the

The existence of a living will facilitates this process as Tier 1 Financial Holding Companies (as defined by the supervisory body)[170] would be forced to submit a resolution plan to the regulatory authority detailing an organizational structure with a plan for the orderly wind-down of certain sections of the institution with minimal impact on related sections or counterparties.[171] To allow for this, those sections

advantages and disadvantages of offering securities services in-house with those resulting from offering them through a separately capitalized unit. Because these effects vary with the securities activities and with factors intrinsic to each bank (such as reputation), some banks would offer their securities services through an in-house department and others would choose to conduct the securities business in a separate unit, under either a bank parent model or a holding company model. . . . Correcting the distortions at their source (for example, ending the too-big-to-fail policy, requiring market-value accounting, introducing more risk- sensitive insurance premiums and capital requirements and adopting a prompt corrective action procedure) and allowing banks to choose the conglomerate model they find most efficient appears to be a more appropriate policy than maintaining the distortions from the safety net and using them to justify the introduction of another layer of distortions, such as those that would result from a regulation requiring corporate separateness."). Instead of a uniformly mandated divide between commercial and investment banking functions (the goal of Glass-Steagall), the use of living wills (in conjunction with capital requirements, etc.) would allow banks to determine their own corporate structure (to capture whatever efficiencies may exist) with risk management in mind.

[170] Walter, *supra* note 30, at 26 ("Criteria for classification as a Tier 1 firm [could] include the impact a firm's failure would have on the financial system and the economy; the firm's combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and the firm's criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system, especially under stressed economic conditions.").

[171] *See, e.g.*, Brooke Masters & Gillian Tett, *UK Regulators Step Up Efforts To Force Banks to Compile Living Wills*, FIN. TIMES, Sept. 16, 2009, at 15 (describing the U.K. model where "banks will have to meet three requirements. They need to outline which businesses and subsidiaries they would sell to raise emergency funds. They will also have to put together a 'contingent resolution plan' for transferring client assets to a third party in a crisis to reduce the infrastructure exposure of the firm. Finally, they will have to stipulate how they would liquidate the assets on their trading book within 60 days. . . . The requirements are expected to

must necessarily be fenced off from the related sections or counterparties.[172] By engaging in the exercise of developing the living will, banks would be forced to reconfigure their internal frameworks along more substantive lines (perhaps even along the Glass-Steagall demarcation), simplifying and rendering more transparent their internal mechanisms to more clearly expose risk.

The use of living wills to manage systemic financial institutions is currently being tested in the U.K.[173] The U.K. model requires designated banks in the pilot program to submit both a recovery and resolution plan.[174] The resolution plan requires firms to explain the relationship between the different entities within a group, the basis of that relationship, and contingency arrangements in case of disruption. In order to do this, however, the firm's legal structures must be sufficiently clear to allow a third-party regulator to effectively exercise its supervisory function.[175] A similar plan, implemented in the United States for certain financial institutions posing high systemic risk, could, by forcing firms to clearly explain the interconnectedness of

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compel many banks to rethink the complicated legal structures that have developed over the years."); *see also Death Warmed Up*, *supra* note 11.

[172] This can be done in multiple ways. For example,

> [i]n the bank parent model, the securities business is undertaken by a subsidiary of the bank. There is a legal separation between the bank and the securities unit. This imposes some operational separateness between the activities conducted by the two units and, because of limited liability, it confines the bank's loss to its investment in the subsidiary in the event that the securities unit should fail.

Santos, *supra* note 27, at 96. Alternatively, "in the holding company model, a holding company owns both the bank and the securities subsidiary. As in the bank parent model, there is a legal separation between the two units." *Id.*

[173] Masters & Tett, *supra* note 171.

[174] *Id.*

[175] *Id.*

their activities, assist in the ring-fencing project, and ultimately lead to safer banking practices.[176]

Requiring ring-fencing of operations via a living-will regime would change banks' incentive structures in favor of safer practices. In his defense of Gramm-Leach-Bliley, Kane discusses the tension between regulatory changes and loophole-seeking behavior, noting that "regulation begets avoidance activity, and avoidance eventually begets some form of re-regulation."[177] Instead of focusing regulatory efforts on matching the speed of financial innovation, an endless and difficult task,[178] proposals giving increased importance to the living-will conception would force financial institutions to self-regulate by identifying and isolating potentially unstable assets.[179] Where rigid regulatory structures (such as an externally imposed Glass-Steagall divide) may in fact serve to encourage regulatory arbitrage, the more flexible living will proposition would better create incentives aligned with regulatory goals.[180] As an alternative solution, living wills, which would regulate activities from within financial institutions, would simplify rather than

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[176] *See* Bootle, *supra* note 77, at 214 ("[M]odern banking has represented a union between a utility and a casino. . . . A key part of the reform of the system will be ensuring a divorce between these two ill-starred partners. Whatever the precise form of the restrictions, the aim will surely be to ring-fence the boring, essential functions of the banking system—such as money transfer, simple savings accounts, and plain vanilla lending—from the racier bits. There would be strict limits on what a banking utility could do. Its functions would be to administer the payments system, and to provide simple deposit and savings products and simple loan services.").

[177] Kane, *supra* note 37, at 7 ("The current crisis tells us that, in recent years, across the chain of adjustments by regulators and regulated institutions, risk-taking incentives became more and more dangerously misaligned with societal interests.").

[178] *Id.*

[179] What constitutes potentially unstable assets and what structures should be created is a question for further scholarship, outside of the purview of this Note.

[180] Kane, *supra* note 37, at 7.

further complicate regulatory structures, rendering such a measure more immune from traditional avoidance activity.[181]

B. Ramifications for Financial Institutions

The problem with this conception rests in the difficulty of implementing such a project. The process of dismantling global banks has been likened to unscrambling an egg.[182] Demanding clarity of legal structures will require the unraveling of extraordinary structural complexity designed for regulatory and tax arbitrage.[183] Unwinding subsidiary and branch structures may take several years. Moreover, changing these structures will inevitably render large banks less tax-efficient and thereby cost them hundreds of millions of dollars, an idea that will surely be unpopular with the banking lobby.[184] In fact, industry executives and lawyers will likely argue that such a proposal will make it "more expensive to do business during less turbulent times."[185]

However, it is these turbulent times that demand change, regardless of how gradual the process may be. Capital and liquidity requirements may address concerns in the short-term; however, adopting reform measures with a longer outlook can effect more radical change through a simplification of financial architecture.[186] While the project may be slow and iterative, living wills over time may prove significant in creating transparency in global banking

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[181] *Id.*

[182] *Death Warmed Up*, *supra* note 11.

[183] *Id.*

[184] *Id.*

[185] Labaton, *supra* note 111.

[186] Former Treasury Secretary Henry Paulson noted in a Treasury Fact Sheet, "we should and can have a structure that is designed for the world we live in, one that is more flexible, one that can better adapt to change, one that will allow us to more effectively deal with inevitable market disruptions and one that will better protect investors and consumers. The challenge is to evolve to a more flexible, efficient and effective regulatory framework—and that is the purpose of this Blueprint." U.S. Dep't. of Treasury, *Treasury Fact Sheet.* Mar. 31, 2008, *available at* http://www.treas.gov/press/releases/reports/Fact_Sheet_03.31.08.pdf.

structures that allow for more efficient regulation.[187] Lobbying efforts from the banking sector should not be permitted to derail efforts to create a more simplified organizational structure that is better able to deal with the next financial crisis.

Nevertheless, living wills have found support from prominent members of the banking community. Howard Davies of the London School of Economics notes that "we need to go through the exercise of trying to understand, for a number of different institutions, precisely how they connect in with the rest of the financial sector and what would happen if they went down."[188] Alistair Darling, the U.K.'s Chancellor of the Exchequer, also argues that the too-big-to-fail problem may be better addressed through the living will approach, in which organizational structure is understood in advance of potential dissolution.[189] Mario Drahi, chairman of the Financial Stability Board, concurs, noting that preparedness for financial crisis is better achieved through living wills defined by financial institutions themselves.[190] Lastly, Alessandro Profumo, CEO of UniCredit Group, has also supported the idea, commenting that living wills may be

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[187] *Id.*

[188] Alan Murray, *Getting Started*, WALL ST. J., Dec. 14, 2009, at R4 (quoting Professor Howard Davies).

[189] Robert Thomson, *The View from Britain*, WALL ST. J., Dec. 14, 2009, at R8 (quoting Alistair Darling as arguing that, "I do not think that it is right or possible for a government or regulator to say that a bank can only go to this size, and after that somehow you cap it and it has to do something different. . . . [T]he better way to deal with that is colloquially called the 'living will' approach, where the regulator understands that if a big bank gets in trouble, you understand in advance how to deal with it. What would you do domestically, and what would you do with the other regulators concerned? What plans has the bank got to insulate some of that risk? What would you need to step in and save? What are things you would let go").

[190] Alessandra Galloni, *The Regulator's Reaction*, WALL ST. J., Dec. 14, 2009, at R2 (quoting Marco Draghi arguing that, "[t]o the extent that you have to rely on help from the institution themselves, you should ask them to have living wills").

integral to maintaining discipline in financial institutions.[191] Even with such support, living wills have received little attention in the United States as a response to the financial crisis, where they have been overshadowed by debate on more direct Glass-Steagall reform. An increased focus on the idea is warranted in the upcoming discussions on improving financial regulation.[192]

C. Living Wills and the Too-Big-to-Fail Problem

Critics of the living will proposal will likely argue that it leaves too-big-to-fail institutions intact until they become troubled.[193] Instead, the argument goes, too-big-to-fail institutions should be broken up long before they fail, or, at the very least, reform should impose limits on bank size or trading activity.[194] However, by mandating that financial institutions create living wills, such results may be achieved from within global banks.[195]

The current U.S. banking system provides a confusing, overlapping, and arguably ineffective framework for financial regulation.[196] Many would seek drastic overhaul, re-regulating banking through targeted monitoring of financial instruments.[197] However, as several observers

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[191] Ken Brown, *Too Big to Fail,* WALL ST. J., Dec. 14, 2009, at R5 (quoting Alessandro Profumo noting that, "[w]hat we think is very important is that the board and the management are being forced to think about how they can manage an eventual crisis situation. To have these living wills prepared within the company and to discuss it with regulators is quite important in terms of discipline for the company").

[192] *A Call to Action*, WALL ST. J., Dec. 14, 2009, at R2 (listing the development of living wills as one of twenty reform measures proposed by the Wall Street Journal's Future of Finance Initiative).

[193] *Death Warmed Up, supra* note 11.

[194] *Id.*

[195] *Id.*

[196] Rose Marie Kushmeider, *The U.S. Federal Financial Regulatory System: Restructuring Federal Bank Regulation*, 17 F.D.I.C. BANKING REVIEW 4 (2005), *available at* http://www.fdic.gov/bank/analytical/banking/2006jan/article1/index.html#2.

[197] Mayer, *supra* note 73, at 11 ("If we could make the world afresh, we would re-regulate banking by control over the instruments that insured

conclude, such drastic change is unlikely to occur in the midst of the current crisis.[198] Even a return to the past is unlikely. The political infeasibility of resurrecting Glass-Steagall, combined with its ramifications for recently consolidated institutions, render the passage of a bill such as McCain-Cantwell wishful thinking.[199]

However, the too-big-to-fail institution certainly remains a serious problem that regulatory reform must address.[200] Corporate living wills meet this challenge by allowing banks to reach a size that poses systemic risk but then forcing them to account for their own dissolution in event of failure.[201] In fact, it is notable that living wills do allow for large banks that carry out both investment-banking and deposit-taking activity. Allowing banks to engage in cross-border transactions may be necessary to achieve effective competition in the global marketplace.[202] Living wills would permit the integrated activity that a return to Glass-Steagall would prohibit while providing Glass-Steagall-like protection to commercial banking activity in the event of financial crisis through ring-fencing. Moreover, even if financial

depositories were permitted to trade and to hold as investments. Thirty years have passed since Scott Pardee, then the chief foreign exchange trader at the Federal Reserve Bank of New York, first proposed the creation of a financial Food and Drug Administration empowered to prevent the marketing or use of instruments with the potential to destabilize our financial systems. . . . Elizabeth Warren at Harvard made a similar suggestion about a year ago, urging a vetting process especially for the trading instruments that can be created ad lib.").

[198] *Id.*

[199] *See supra* Part III.C.5 (discussing the McCain-Cantwell bill).

[200] *See Bair Statement*, *supra* note 2.

[201] *Id.*

[202] *See* TURNER REVIEW, *supra* note 7. *But see* Walter, *supra* note 30, at 10 (noting that academics are unclear whether such diversification is truly necessary for efficiency: "The question as to whether economies or diseconomies of scale exist in financial services has been at the heart of strategic and regulatory discussions about optimum firm size in the industry. Are larger firms associated with increased scale economies and hence profitability and shareholder value? Does increased average firm size create a more efficient financial sector? Answers are not easy to find.").

diversification is necessary for competitive banking activity, the creation of living wills would force institutions posing systemic risk to downsize when the costs of simplifying organizational structure outweigh the benefits of flexibility in banking operations.[203] In either case, living wills supervised by a regulatory body would address the too-big-to-fail concern with the spread of contagion by allowing a failure in one sector of a systemic-risk-posing financial institution to be resolved without affecting other unrelated sectors.

IV. CONCLUSION

A strong financial system is vitally important not just for Wall Street but for Main Street.[204] While current proposals make significant strides towards reforming the American banking system, more attention should be paid to living wills to effect the Glass-Steagall divide, which is likely impracticable through a direct Congressional mandate.[205] By moving away from rules to principles, by shifting focus from prescription to disclosure, the exercise of creating living wills is likely to force financial institutions that pose systemic risk to create an internal boundary between speculative and safe banking activity.[206] While this proposal will undoubtedly face resistance from the banking lobby, the political climate, tense from the expenditure of taxpayer dollars to save troubled banks, may force institutions to comply and accept responsibility for their own demise.[207] The primary purpose of regulation should be to protect the public interest, not the

[203] *See* Walter, *supra* note 85, at 29 (noting the regulatory "incentive to apply serious safety and soundness policies on their financial firms . . . and then let the firms decide whether they should change their business models to avoid the costs").

[204] *See Bair Statement, supra* note 2.

[205] *See supra* Part III (discussing proposals for financial reform).

[206] *See supra* Part IV (discussing living wills).

[207] *See* Walter, *supra* note 30, at 29 ("On the positive side, the threat of financial fragmentation has provided a fear factor among politically powerful systemic firms, possibly undermining their resistance to other, less damaging regulatory options.").

private interests of the financial services industry. Living wills, however unfavorable in the short term to global banks, may be one of the better long-term solutions to the too-big-to-fail problem.