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What Is Past Is Prologue: Why Congress Should Reject Current Financial Reform Bills and Breathe New Life Into Glass-Steagall

Noelle T. Heintz

Robert M. Travisano

WHAT IS PAST IS PROLOGUE: WHY CONGRESS SHOULD REJECT CURRENT FINANCIAL REFORM BILLS AND BREATHE NEW LIFE INTO GLASS-STEAGALL.*

I. INTRODUCTION

In the midst of the stock market crash,[1] Congress enacted the Glass Steagall Act[2] ("Act") to promote consumer confidence in the United States' banking industry. During that time, American scholars and government leaders believed that the widespread, speculative securities activities of commercial banks precipitated the stock market's collapse.[3] Not surprisingly, the

* This Note was originally drafted in late 1997. Since that time, the legislation discussed, H.R. 10, passed the House of Representatives by a vote of 214-213 in the 105th Congress. The bill proceeded to the Senate and was referred to the Committee on Banking, where it was ordered reported with an amendment. A motion to proceed to the Senate passed by a vote of 88-11. The measure was presented before the Senate by unanimous consent on October 8, 1998. Subsequently, Senator Lott moved to recommit the measure to the Committee on Banking. The Senator also proposed a few amendments. However, the measure never made it out of the Senate during the 105th Congress. In 1999, at the start of the 106th Congress, Rep. James Leach introduced a bill to the House that was substantially similar to the previous bill brought before the 105th Congress. Representative Leach's bill reflected some Senatorial amendments and concerns. The new form of the bill does not affect the discussion in this Note, because the two bills in general, and the sections focusing on the mixing of investment and commercial banking specifically, are nearly identical. For the latest update on this legislation, please see:<http://thomas.loc.gov.>.

1 *See* Michael P. Kenney & Teresa D. Thebaut, *Misguided Statutory Construction to Cover the Corporate Universe: Misappropriation Theory of Section 10(b)*, 59 ALB. L. REV. 139, 146 (1995) (describing how public viewed 1929 stock market crash as cause of great depression); Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1464 (1997) (stating that Congressional and public opinion drew causal link between stock market crash and Great Depression); Steve Thel, *The Original Conception of Section 10(b) of the Securities and Exchange Act*, 42 STAN. L. REV. 385, 406 (1990) (expressing that public sentiment saw 1929 stock market crash as cause of Great Depression).

2 *See* 12 U.S.C.A. § 227 (1988).

3 *See* Stephen K. Halpert, *The Separation of Banking and Commerce Reconsidered*, 13 J. CORP. L. 481, 493 (1988) (stating that prohibitions on engagement by commercial banks in investment banking were enacted to combat banking industry's tendency to incur episodes of bank panic and regional banking collapse); Leon Korobow, *Breaking Glass Steagall Chains*, J. OF COM., June 4, 1997, at 8-9 (contending that permissible affiliations between commercial banks and securities firms had contributed to severity and duration of collapse of banking systems as well as general economy of that era); Don More, *The*

public's faith in banks was shattered and the future of the industry was in peril.[4] In an effort to restore the public trust, Congress passed the Glass-Steagall Act,[5] which prohibited commercial banks from engaging in securities transactions.[6]

Since the passage of the Act, significant changes have occurred that have transformed the financial services industry causing some to question the Act's viability in modern markets.[7] Presently, the industry's structure is a patchwork of judicial and

Virtues of Glass Steagall: Argument Against Legislative Repeal, 1991 COLUM. BUS. L. REV. 433, 436 (1991) (stating that public confidence in banks hit rock bottom before passage of Glass-Steagall); Walter Henry Goodwin, Comment, *Fifty-Two Years After the Glass-Steagall Act: Do Commercial Bank Securities Activities Merit a Second Look?*, 1984 DET. C. L. REV. 933, 936 (1984) (stating that Act's objective was to protect bank depositors from repetition of widespread bank closings that occurred during Great Depression); Frank M. Tavelman, Note, *American Banks or the Glass-Steagall Act- Which Will Go First?* 21 SW. U.L. REV. 1511, 1512 (1992) (indicating Congressional intent of Banking Act of 1933 was to provide for safer banking).

4 *See* Edward D. Sullivan, *Glass-Steagall Update: Proposals to Modernize the Structure of the Financial Services Industry*, 112 BANKING L.J. 977, 977 (1995) (stating that Glass-Steagall Act was passed as emergency mechanism to promote bank soundness); *see also* Michael A. Raffanti, *Erosion of Subtle Hazards Analysis Jeopardizes Safety and Soundness of Banking System*: Securities Industries Association v. Board of Governors, 30 B.C. L. REV. 937, 937 (1989) (describing how public saw bank abuses as cause of market crash, thereby undermining its faith in banking industry); Steven D. Kaye & Jack Egan et. al., *Mega Merger One Stop Shopping is a Mixed Bag for Banking Consumers*, U.S. NEWS & WORLD REP., Apr. 20, 1998, at 60-62 (explaining that law was introduced to keep securities firms from using bank deposits to support risky investments).

5 *See* Melanie L. Fein, *The Evolution of Bank Securities Activities*, *in* Securities Regulation of Banks and Thrifts 1991, at 793, 796 (PLI Corp. L. and Practice Course Handbook Series No. B4-6969, 1991) (stating that it is familiar history that Glass-Steagall was passed to protect public from widespread bank closures that occurred during the Great Depression); Nicholas Theodore Nikas, *Banking Law-Commercial Paper Is a Security Under the Glass-Steagall Act*-Securities Industry Association v. Board of Governors of the Federal Reserve System 104 S.Ct. 2979 (1984), 1985 ARIZ. ST. L. J. 799, 800 (1985) (describing how Congress' intent in passing Glass-Steagall was to restore public confidence in banking industry).

6 *See* J. Robert Brown, Jr., *The Great Fall: The Consequences of Repealing the Glass-Steagall Act*, 2 STAN. J. L. BUS. & FIN. 129, 130 (1995) (arguing that Glass Steagall Act kept commercial banks out of corporate securities underwriting business); More, *supra* note 3, at 435 (contending that Glass-Steagall Act prevented commercial banks from engaging in securities activities through affiliates, practice which led to rampant abuses in 1920's); Jeffrey L. Elverman, Note, *Units of Participation in IRA Common Trust Funds Offered by Commercial Banks: A Violation of the Glass-Steagall Act?*, 60 NOTRE DAME L. REV. 745, 748 (1985) (stating that Glass-Steagall attempts to separate commercial and investment banking industries).

7 *See* Robert S. Plotkin, *What Meaning Does Glass-Steagall Have for Today's Financial World?*, 95 BANKING L.J. 404, 406 (1978) (characterizing Glass-Steagall as statutory overkill); William E. Whitesell & Janet F. Kelly, *Is the Glass-Steagall Obsolete?*, 87 BANKING L.J. 387, 403 (1970) (arguing Glass-Steagall Act is obsolete). *See generally Banker's Trust Agrees to Buy Alex. Brown*, L.A. TIMES, Apr. 8, 1997, at D1 (stating that Banker's Trust N.Y. Corporation's acquisition of Alex. Brown Inc. is most dramatic result to date of gradual steps to allow banks to engage in more bank underwriting and trading, toppling "walls that have separated banks from the brokerage industry since the Great Depression").

regulatory decisions[8] that Congress must reform if the U.S. is to remain a global financial leader.[9] It is asserted, however, that these changes should not drastically alter the bedrock principles upon which Glass-Steagall was based.

For the past twenty years,[10] members of Congress have proposed various financial modernization models, none of which have achieved the consensus needed to become law.[11] Powerful interest groups, including members of the banking, securities and insurance industries, have effectively derailed every proposal initiated.[12] Nevertheless, during the 105th Congress, a new

8 *See The "Depository Institution Affiliation and Thrift Charter Conversion Act," 1997: Hearings on H.R. 268 Before the SubCommittee on Financial Institutions and Consumer Credit of the House Committee on Banking and Financial Services*, 105th Cong. (1997), *available in* 1997 WL 8219185, at *10 (statement of Marc E. Lackritz, President of Securities Industry Association) (discussing pattern of piecemeal regulatory revision of the Glass-Steagall Act resulting in unbalanced and confusing regulatory structure). *See generally* David M. Eaton, *The Commercial Banking-Related Activities of Investment Banks and Other Non-Banks*, 44 EMORY L.J. 1187, 1225 n.3 (1995) (noting that agencies and courts frequently interpret provisions of Glass-Steagall); A.J. Herbert, III, Comment, *Requiem on the Glass-Steagall Act: Tracing the Evolution and Current Status of Bank Involvement in Brokerage Activities*, 63 TUL. L. REV. 157, 157 (1988) (commenting on historical account of Glass-Steagall Act's supplementation).

9 *See Markup of H.R. 10, Financial Services Modernization Legislation Before House Banking and Financial Services Committee*, 105th Congress (1997), *available in* 1997 WL 4434040, at *6 ("If Congress does not restructure the financial services industry, the industry may restructure itself in a way that will reduce rather than strengthen the nation's position as a leader in the Global financial services marketplace." (quoting David Komansky, Chiarman, Merrill Lynch)); Christopher T. Toll, *European Communities Second Banking Directive: Can Antiquated U.S. Legislation Keep Pace?*, 23 VAND. J. TRANSNAT'L L. 615, 615 (1990) (noting that Europe's second banking directive sought to avoid principles of Glass-Steagall governed banking system, which it viewed as preventing United States from more efficient action in global markets).

10 *See* Jim McTague, *Empty Glass-Steagall? Banking-Reform Bill Unlikely This Year, but Mergers Won't be Deterred*, BARRON'S, Apr. 13, 1998, at 20 (stating that various legislators have attempted to reform financial services industry since at least 1979).

11 *See* More, *supra* note 3, at 443 (stating that although Glass-Steagall has been criticized as "depression era relic" Congress has considered, but not enacted number of proposals that would repeal act); *Regulatory Reform in Transition: the Dismantling of the Glass-Steagall Act*, 47 ADMIN. L. REV. 545, 547 (1995) (indicating that serious efforts to reform financial services industry were attempted in 1988 and 1991); *see also* William M. Isaac & Melanie L. Fein, *Facing the Future: Life Without Glass Steagall*, 37 CATH. U. L. REV. 281, 281 (1988) (discussing how numerous bills have been introduced to dismantle Glass-Steagall including Proxmire Financial Modernization Act of 1988).

12 *See Bankers Trust Agrees to Buy Alex. Brown*, L.A. TIMES, Apr. 7, 1997, at D1 (stating that various segments of financial services industry have bogged down Congressional legislation for more than ten years, as they attempt to influence the debate among lawmakers); *see also* Isaac & Fein, *supra* note 11, at 282 (noting that Glass-Steagall Reform has been held up in Congress due to opposition of industries facing competition from banks, such as real estate and insurance as well as certain consumer groups); Jonathan R. Macey, *Fed Does End Run on Glass Steagall*, NAT'L L. J., Apr. 28, 1997, at A21 (noting that a host of interest groups are resisting Glass-Steagall reform); *Will Financial Services Reform Pass This Fall?*, FUND ACTION, Sept. 8, 1997, at 10 (noting that even if Congressional session extends beyond October, competing interests of mutual funds, securities firms, banks and insurance companies will most likely curtail ultimate restruc-

reform bill, entitled the Financial Services Competitiveness Act, ("H.R. 10") garnered substantial support.[13] Although H.R. 10, which effectively eliminates the separation of banking and commerce, has yet to pass both houses of Congress, the concepts it engenders are critical to financial modernization.[14]

This Note asserts that the provisions in H.R. 10 weaken the financial services industry by permitting the integration of commerce and banking. Part I of this Note discusses the history of the Glass-Steagall Act and the evolution of the modern financial industry. Part II describes how key provisions of H.R. 10 will weaken the banking and finance industry. Part III provides convincing reasons to oppose the enactment of a mixed banking and commerce system such as H.R. 10. This Note concludes with the proposition that, despite being viewed as antiquated, Glass-Steagall is structurally safer for the United States' economy than other plans to integrate banking and commerce.

A. History of the Glass-Steagall Act

In 1933, during the Great Depression, Congress passed the Glass-Steagall Act to restore the American public's faith in the banking industry.[15] The utility of the Act in our modern finan-

turing of financial services).

13 *See* Jeffrey Taylor, *House Committee Votes to Let Banks Affiliate with Non-Financial Companies*, WALL ST. J., June 18, 1997, at A4 (discussing how House Banking Committee voted 35-19 to approve provision that would allow bank holding companies to affiliate with non-financial companies); *House Commerce Democrat Steps Into Reform Debate*, BANKING POL'Y REP., Sept. 1, 1997, at 3 (stating House Banking Committee approved Financial Services Competition Act of 1997 on June 20, and subsequently referred to House Commerce Committee); *House Panel Ok's Bill Allowing Banks, Brokerages to Merge; 28-26 Vote Follows Heavy Lobbying by Financial Industries*, BALT. SUN, June 21, 1997, at 9C (discussing how H.R. 10 passed House Banking Committee and then moved to full House for vote).

14 *See* Brett D. Forsman, *House Panel Backs Banking - Commerce Mix*, WASH. POST, June 18, 1997, at C13 (discussing House Banking Committee vote to allow banks to buy commercial companies); William Gruber, *Chains on Banks Still Strong Uphill Battle Still Seen on Glass-Steagall*, CHI. TRIB., July 8, 1997, at 1 (stating that if H.R. 10 were passed, banks could own non-financial companies and vice versa); Jeffrey Taylor, *Citicorp Motors? Panel to Take Up Bank Merger Law*, WALL ST. J., June 3, 1997, at A24 (stating that H.R. 10 would permit banking and commerce mix).

15 *See* Mary Margaret Cluck, *Mortgage Backed Securities and Consumer Related Receivables: A Lesson From the Past With an Eye Toward the Future*, 50 U. PITT. L. REV. 227, 231 (1988) (stating that with Glass-Steagall, Congress sought to curtail national banks' action in securities market so as to boost public confidence in industry); Emerick Fisher, *Banking and Insurance-Should Ever the Twain Meet?*, 71 NEB. L. REV. 726, 737 (1992) (stating that Congressional intent behind passage of Glass-Steagall was reformation and recovery of banking system as well as restoring public confidence in it); Joan M. Legraw & Stacy L. Davidson, *Glass-Steagall and the "Subtle Hazards" of Judicial Activ-*

cial system, however, has encountered much debate.[16]

Congress enacted Glass-Steagall[17] as a prophylactic measure to ensure security in the financial industry.[18] As such, Glass-Steagall prevented commercial banks from partaking in securities activities.[19] Prior to the Act's enactment, investors commonly used commercial bank loans for high-risk stock transactions.[20] The public, as well as legislators, believed that such practices were a major cause of the Great Depression.[21] Thus,

ism, 24 NEW. ENG. L. REV. 225, 226 (1989) (stating that motive behind Glass-Steagall was to restore public confidence in industry by disallowing banks from dealing in securities).

16 *See* Jonathan Zubrow Cohen, *The Mellon Bank Order: An Unjustifiable Expansion of Banking Power*, 8 ADMIN. L.J. AM. U. 335, 340 (1994) (discussing how some critics have called Glass-Steagall obsolete and called for its explicit repeal); Donna L. Lance, *Can the Glass-Steagall Act be Justified Under the Global Free Market Policies of the Nafta?*, 34 WASHBURN L.J. 297, 307 (1995) (questioning whether Glass-Steagall serves goal of providing environment where banking industry can thrive); Joan K. Willen, *Commercial Banks and the Glass-Steagall Act: A Survey of New Products and Activities*, 104 BANKING L.J. 5, 6 (1987) (stating that Act is obsolete in light of new economic realities).

17 *See* 12 U.S.C. §§ 24,377, 378, and 78 (1982). This note follows the common usage that "Glass-Steagall Act" refers to four provisions of the Banking Act of 1933 that separate commercial and investment banking.

18 *See* Joseph Michael Heppt, *An Alternative to Throwing Stones: A Proposal for the Reform of Glass-Steagall*, 52 BROOK. L. REV. 281, 281-82 (1986) (noting that Glass-Steagall attempted to rectify banking industry indiscretions by prophylactic measures or erecting wall between commercial and banking industries); D.A. Howard, *Ownership of Member Banks by Mutual Fund Advisors Under the Glass-Steagall Act*, 52 FORDHAM L. REV. 691, 691 (1984) (stating that Glass-Steagall sought to alleviate bank instability, conflicts of interest and investor deception); Jonathan R. Macey, *Special Interest Groups Legislation and the Judicial Function: Dilemma of Glass-Steagall*, 33 EMORY L. J. 1, 5 (1984) (discussing enactment of Glass-Steagall in order to stabilize activities of commercial and investment banks).

19 *See* Rachel F. Robbins, *Court Challenges in the Glass-Steagall Area: Practical Implications*, at 596 (PLI Corp. L. and Practice Course Handbook Series No. B4-6827, 1988) (discussing Glass-Steagall's prohibition that commercial banks could not engage in securities activity); Jeffrey L. Elverman, *Units of Participation in IRA Common Trust Funds Offered by Commercial Banks: A Violation of the Glass Steagall Act?*, 60 NOTRE DAME L. REV. 745, 745 (1985) (stating that Glass Steagall Act mandated separation between commercial and investment banks); Casey K. McGarvey, *Federal Regulation of Bank Securities Activities: Will Congress Allow Glass-Steagall to be Shattered?*, 12 J. CONTEMP. L. 99, 99 (1986) (noting Glass-Steagall's prohibition of commercial banks' engagement in securities activities).

20 *See* John K. Forst, *Legislative Reform of Glass Steagall: Bank Sponsorship and Distribution of Mutual Funds is Long Overdue*, 19 CAP. U. L. REV. 521, 526 (1990) (discussing Congress' belief that pre-division activities of commercial and investment banks gave rise to imprudent lending practices); Bevis Longstreth & Ivan E. Mattei, *Organizational Freedom for Banks: The Case in Support*, 97 COLUM. L. REV. 1895, 1895 (1997) (discussing idea that securities underwriting/dealing was unacceptable threat to banks' safety and soundness); Kurtis J. Polk, *Banking and Securities Law: The Glass-Steagall Act-Has It Outlived Its Usefulness?*, 55 GEO. WASH. L. REV. 812, 812 (1986) (discussing Congress' belief that commercial bank failures during depression were brought about by banks investing in and lending for speculative securities).

21 *See* Steven P. Kenkell, *The D.C. Circuit Affirms Further Bank Expansion into Se-*

political climate of the 1930's precipitated the need for legislation aimed at restoring the overall faith in the strength of the banking industry.[22]

The Glass-Steagall Act, contained within four sections of the Banking Act of 1933,[23] curtailed the security activities of commercial banks.[24] Section 16[25] (i) prohibits a bank from buying stocks for its own account (ii) imposes limits on its authority regarding debt instruments; and (iii) prohibits underwriting and dealing in securities unless they are "bank eligible securities."[26] Section 20, moreover, prevents member banks of the Federal Reserve from affiliating with any company "engaged principally" in securities transactions.[27] In addition, section 21 restricts investment banks from engaging in commercial banking.[28] Finally, section 32 prevents the directors, officers, employees or princi-

curities Businesses, 56 GEO. WASH. L. REV. 736, 738 (1988) (attributing large part of bank failures to speculative activities later remedied by drastically curtailing bank securities activities); Scott D. Osborn, *Discount Brokerage Services, The Glass-Steagall Act and Branch Banking in Texas*, 16 ST. MARY'S L. J. 185, 195 (1984) (discussing idea that investment dealings by banks were at least part of cause of depression era bank failures).

22 *See Regulatory Reform, supra* note 11, at 546 (stating that Congress enacted Act in reaction to public outcry for corrective measures).

23 12 U.S.C.A. § 227.

24 *See* William J. Shafer, *Glass-Steagall Reform: Its Time to Replace the Crumbling Wall*, 14 J. CORP. L. 973, 978 (1989) (explaining that these four sections are designed to address specific problems arising from bank involvement in investment activities).

25 Banking Act of 1933, ch.89, § 16, 48 Stat. 184 (codified with some differences at 12 U.S.C. § 24 (1988)). Section 16 of the Banking Act states that:

> [T]he business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issues of security or stock. . . .

Id.

26 *See* Shafer, *supra* note 24, at 978 (explaining three components of section 16 of Banking Act of 1933).

27 *See id.* § 20, 48 Stat. 162, 188 (codified as amended at 12 U.S.C. § 377 (1988)). This section states that:

> [N]o member bank shall be affiliated in any manner described in subsection (b) of section 22 1a of this title with any corporation, association, business trust, or other similar organizations engaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks. . . .

Id.

28 *See* Banking Act of 1933, *supra* note 25, at ch. 89, § 21 (codified as amended at 12 U.S.C. 378 (1988)). Section 21 states that:

> [I]t shall be unlawful (1) [F]or any person, firm, corporation, association, business trust, or other similar organization, engaged in the business of issuing, underwriting, selling, or distributing, at wholesale or [retail, or through syndicate participation, stocks, bonds, debentures, notes, or other securities, to engage at the same time to any extent whatever in the business of receiving deposits. . . .

Id.

pals of commercial banks from simultaneously serving in those capacities at a firm that are "primarily engaged in" investment banking.[29]

In *J.P. Morgan v. SEC*,[30] a bank holding company("BHC") successfully challenged the "engaged principally" language in section 20 of the Act.[31] The Supreme Court held that a BHC could establish a "securities arm" as long as the revenues from the securities transactions did not exceed ten percent of the gross domestic revenue.[32] Subsequently, in December 1996, the Federal Reserve Board increased the amount that banks could earn from security underwriting from ten to twenty-five percent.[33] This increase cleared the way for a merger, the magnitude of which was previously unseen, between a commercial bank, Bankers Trust New York Corp. and Alex Brown, the oldest brokerage firm in the country.[34]

29 *See id.* at § 32, 194 (codified as amended at 12 U.S.C. § 78 (1988)). This section states that:

> [N]o officer, director, or employee of any corporation or unincorporated association, no partner or employee of any partnership, and no individual, primarily engaged in the issue, flotation, underwriting, public sale, or distribution, at wholesale or retail, or through syndicate participation, of stocks, bonds, or other similar securities, shall serve the same time as officer, director, or employee of any member bank. . . .

Id.

30 75 Fed. Res. Bull. 192 (1987).

31 *See id.* at 194 (allowing bank affiliates to underwrite and deal in bank ineligible securities as long as such activity is limited to five to ten percent of affiliates' gross revenues).

32 *See* Shafer, *supra* note 24, at 973 (stating that Board's determination allowed bank affiliates to underwrite and deal in bank ineligible securities provided that activity was between five and ten percent of affiliate's gross revenue); *see also* Stephen Phillips, *Federal Reserve Eases Restrictions on Bank Activities*, PLAIN DEALER, Dec. 21, 1996, at C1 (stating that attorneys for J.P. Morgan & Co. successfully argued that Morgan could deal in securities to limited extent); *Regulatory Reform*, *supra* note 11, at 560 (discussing J.P. Morgan's engagement in securities attributed to relaxation of Glass-Steagall provisions).

33 *See* Rob Wells, *Fed Expands Bank Underwriting Powers*, ASSOCIATED PRESS, Dec. 20, 1996, at D4 (stating that Fed increased amount banks can earn from securities from ten to twenty-five percent of bank's overall revenue); *see also* Dean Foust & Allison Rea, *Crashing Through Glass-Steagall*, BUS. WK., Nov. 4, 1996, at 184 (predicting that Fed was on verge of increasing amount of banks gross revenues derived from securities transactions from ten to twenty-five percent); Edward Hurlihy et. al., *Financial Institutions Mergers and Acquisitions 1996 Another Successful Round of Consolidation and Capital Management, in* FINANCIAL INSTITUTIONS MERGERS AND ACQUISITIONS, at 251, 320 (PLI Corp. L. and Practice Course Handbook Series No. B4-7179, 1997) (discussing easing of regulatory restrictions on Bank holding companies which allow percentage of revenue from ineligible activities to rise to twenty-five percent).

34 *See Bankers Trust Agrees to Buy Alex. Brown Securities*, L.A. TIMES, Apr. 8, 1997, at D1 (explaining that Banker's Trust New York Corp. agreed to purchase brokerage Alex. Brown for $1.64 billion in stock, resulting in one of the biggest acquisitions of securities firm by commercial bank); Jon Birger, *Brokers Lead in Turf Battle: Gain Edge Over Commercial Banks in Swiping Each Other's Business*, CRAIN'S N.Y. BUS., Apr. 21, 1997, at 3 (mentioning effect of merger between Alex. Brown & Co. and Bankers Trust); Edwin

Regulatory and judicial decisions created the twenty-five percent window facilitating the interaction of commercial banks and investment banks.[35] Many commentators believe, however, that Congress has the ultimate responsibility to create an effective blueprint for financial services reform.[36]

B. The Evolution of Modern Financial Practices

The Banking Industry is comprised of banks and bank holding companies.[37] Although they are governed by different regulatory agencies,[38] the provisions of the Act affect both of these entities.[39]

Blount, *Banking in the Third Millenium*, ABA BANKING J., June 1997, at 34 (contending that acquisition of Alex. Brown & Co. would have enormous impact on banking industry); Michelle DeBlasi, *Pumping Up*, BANK INVESTMENT MARKETING, Sept. 1997, at 42 (stating that Bankers Trust Alex. Brown merger was first acquisition of brokerage firm by United States commercial bank possibly marking death of Glass-Steagall); Jill Dutt, *Climbing Over a Banking Barrier; Bankers Trust Bids $1.7 Billion for Alex. Brown; Deal May Spur Changes in Law*, WASH. POST, Apr. 8, 1997, at C1 (contending that merger between Bankers Trust and Alex. Brown Inc. exemplifies disintegration of Glass-Steagall Act).

35 *See Banker's Trust Takes Advantage of New Section 20 Limit*, 16 NO. 8 BANKING POL'Y REP. 12, 12 (1997) (discussing Federal Reserve Board's increase of amount of gross revenue section 20 subsidiary can derive from securities underwriting from ten to twenty-five percent); *Fed Votes to Replace Section 20 Firewalls with New Standards*, 16 NO. 17 BANKING POL'Y REP. 5, 5 (1997) (discussing raise from ten to twenty percent that banks can deal in "bank ineligible" securities without violating Glass-Steagall restrictions); Edward D. Herlihy & Craig M. Wasserman et. al., *Banks are Acquiring Investment Banking Firms at Rapid Pace*, 16 NO. 14 BANKING POL'Y REP. 1, 12 (1997) (explaining that Federal Reserve Board's widening of section 20 window will allow many banks to buy some large broker/dealer franchise).

36 *See Bankers Trust Deal Shows Need For Immediate Action On Financial Modernization*, Government Press Release, Apr. 17, 1997, *available in* 1997 WL 4431654, at *3 (statement of Marge Roukema, Chairperson of House Financial Institutions Subcommittee) (stating that it is duty of Congress to take action in regard to financial modernization and not let that duty pass to regulators and Comptroller of Currency); John J. King, Comment, *The Dangers of Piecemeal Reformation of the United States Banking Industry*, 39 ST. LOUIS U. L.J. 1099, 1127 (1995) (arguing that Congress should abandon piecemeal approach to financial services reform and focus on comprehensive structural reform).

37 *See* PHILIP I. BLUMBERG & KURT A. STRASSER, THE LAW OF CORPORATE GROUPS 177 (1992) (stating that industry consists of banks and bank holding companies and both entities are subject to separate regulatory schemes administered by distinct federal agencies); Rodgin Cohen & Michael Wiseman, *Improving Banking's Competitive Position: A Modest Proposal*, 12 NO. 19 BANKING POL'Y REP. 1, 19 (1993) (explaining dynamics of financial industry); Mark D. Rollinger, *Interstate Banking and Branching Under the Riegle Neal Act of 1994*, 33 HARV. J. ON LEGIS. 183-84 (1986) (discussing function of banks and banking holding companies in financial services industry).

38 *See* Halpert, *supra* note 3, at 485 (explaining that banks are subject to elaborate system of regulations that involves numerous overlapping federal, as well as state authorities); *see also* Melanie L. Fein, *Fed's Proposed Overhaul of Regulation Y Goes Far, but Could be Bolder*, 15 NO. 20 BANKING POL'Y REP. 4, 4 (1996) (discussing bank holding company regulations undertaken at regulatory level); Stephen J. Friedman & Connie M. Friesen, *A New Paradigm for Financial Regulation Getting from Here to There*, 43 MD. L. REV. 413, 415 (1984) (asserting that federal agencies and individual state agencies regulate banking industry and discussing rapid changes in financial services market that have rendered current regulatory system obsolete).

For two decades after the passage of the Act, banks adhered to its proscriptions and abstained from engaging in securities transactions.[40] By the 1950's, however, the rejuvenated securities industry re-emerged as a competitive threat to the banking industry.[41] As a result of competition with the securities industry, banks began to lose corporate consumers to investment banks that offered loans and other services to customers at lower prices, as well as more competitive interest rates.[42] In response, many banks began utilizing a loophole in the Act that allowed companies to form a "corporate shell" known as a bank holding company.[43] To establish a bank holding company, the parent

39 *See* BLUMBERG & STRASSER, *supra* note 37, at 177-178 (stating that policy behind Glass-Steagall Act was to separate investment banking and commercial banking and it is this policy that informs and influences determinations of acceptable activities under Bank Holding Company Act); *see also* Joseph J. Norton & Christopher D. Olive, *The Ongoing Process of International Banking Regulatory and Supervisory Convergence: A New Regulatory Market "Partnership,"* 16 ANN. REV. BANKING L. 227, 279 (1997) (stating that bank holding companies and banks are subject to Glass-Steagall Act); *Client Memos*, INSIGHTS, July 1993, at 7 (asserting that Glass-Steagall Act inhibits activities of both banks and bank holding companies in context of mutual fund activities).

40 *See Regulatory Reform*, *supra* note 11, at 550 (explaining that banks began to re-engage in securities activities as result of competition between commercial banks and investment banks); George G. Kaufman & Larry R. Mote, *Glass-Steagall: Repeal by Regulatory and Judicial Re-interpretation*, 107 BANKING L.J. 388, 396 (1990) (discussing proposition that state of banking industry following Great Depression deterred widespread efforts by banks to re-enter securities business until 20 years later).

41 *See Regulatory Reform*, *supra* note 11, at 550 (stating that during 1950's banks began to seek ways to avoid Glass Steagall Act in order to remain competitive in industry); *see also* Kaufman & Mote, *supra* note 40, at 395 (asserting that when securities market became profitable again in 1950's banks sought to weaken Glass-Steagall restrictions and conduct securities activities); Stewart J. Vogelsmeier, Note, *Evaluating Bank Commercial Paper Placement Activity Under the Glass Steagall Act*, 65 WASH. U. L. Q. 615, 615 (1987) (stating that banks began to offer services that had traditionally been offered by investment banking sector in response to growth in financial services markets).

42 *See* Isaac & Fein, *supra* note 11, at 294 (explaining how securities firms compete with banks for deposits by providing functional equivalents that are market sensitive); Peter J. Ferrara, *The Regulatory Separation of Banking From Securities and Commerce in the Modern Financial Market Place*, 33 ARIZ. L. REV. 583, 622 (1991) (stating that certain investment banks can provide broader spectrum of products at lower prices than commercial banks); Charles G. Roberts, *He Who Hesitates is Lost, Congressional Inaction and Commercial Banking*, 5 HOFSTRA L. J. 219, 241 (1992) (discussing how banks lost deposits when investors switched to capital markets because they offered better rates than banks); *see also* McTague, *supra* note 10, at 20 (stating that prospect of cross-selling each other's products is driving force behind mega-merger between Travelers and Citigroup).

43 *See Regulatory Reform*, *supra* note 11, at 550 (explaining that banks would form bank holding company to own both bank and non-bank and utilize non-bank in order to circumvent Glass-Steagall provisions); Cohen, *supra* note 16, at 344-345 (discussing that Glass-Steagall Act provoked banks to form bank holding companies as corporate shells to own both banking and non-banking businesses); Carol S. Shahmoon, Note, *Federal Reserve Board Authority Over Bank Subsidiaries Under the Bank Holding Company Act of 1956*, 91 COLUM. L. REV. 965, 976 (1991) (explaining Congress' legislative intent in

company would create a separate subsidiary through which it could conduct securities business.[44] This bank holding company structure allowed the parent companies to circumvent the regulations that governed banks.[45]

To prevent financial service companies from amassing too much power, Congress enacted the Bank Holding Company Act("BHCA").[46] This Act limits bank holding companies to activities "closely related to banking."[47] Despite the fact that BHCA regulations permitted bank holding companies to engage in a limited amount of securities activities, including securities brokering and investment advice, bank holding companies petitioned the Federal Reserve Board to expand these activities.[48]

passing Bank Holding Company Act was to close loop hole that allowed banks to engage in securities activities vis-a-vis non-bank subsidiaries).

44 *See* James J. Croke, Jr., *New Developments in Asset Backed Commercial Paper, in* NEW DEVELOPMENTS IN SECURITIZATION 1997, at 139 (PLI Comm. and Practice Course Handbook Series No. A4-4528, 1997) (noting that in 1987, Federal Reserve Board authorized bank holding companies to create subsidiaries which could engage in underwriting securities); Joyce M. Hansen & Elizabeth Davy et. al., *Swaps & Other Derivatives in 1997 Bank Regulatory Developments, in* SWAPS AND DERIVATIVES IN 1997, at 481, 497-98 (PLI Corp. L. and Practice Course Handbook Series No. B4-7212, 1997) (explaining that securities activities may be conducted by subsidiary of bank holding company); *The Monitor*, 16 NO. 20 BANKING POL'Y REP. 15, 15 (1997) (stating that in 1997 Federal Reserve Board amended limitations established in Bank Holding Company Act and Glass-Steagall Act to allow bank holding company subsidiaries to engage in securities transactions).

45 *See id.*

46 *See* 12 U.S.C. § 1841 (1998) (prohibiting bank holding company from participating in commercial business, as well as other non-financial activities); Aloni Golanski, Note, *Bank Merging and the Implicate Order: Northeast Bank Corp. v. Board of Governors* 17 CONN. L. REV. 861, 866 (1985) (stating that original intent of Bank holding company Act was to define bank holding companies, require divestment of non-banking interests and control their future expansion); Mary Jo Wetmore, Note, *Banking and Commerce: Are They Different? Should They be Separated?*, 57 GEO. WASH. L. REV. 994, 997 (1989) (arguing that Act was intended to deal with two problems: Concentration of commercial bank facilities and combination of banking and non-banking businesses under single control); Michael Schroeder, *It's Alive: Why Glass-Steagall, Reviled for Decades, Just Won't Go Away; Law that Separates Banks, Brokers Always Manages to Find a Patron in Time; Citicorp was a Fan, Before*, WALL ST. J, Apr. 10, 1998, at A1 (stating that Congress did not intervene until fear that BHC's were becoming too powerful).

47 *See* 12 U.S.C. § 1841 (providing prohibitions on roles of Bank holding companies); *see also Regulatory Reform*, *supra* note 11, at 550 (stating that before board approval is granted under BHCA, board administers two-pronged test which is designed to reveal whether proposed activity is "closely related to banking"); Halpert, *supra* note 3, at 489 (stating that affiliates of bank holding companies may only engage in businesses that are "closely related" to banking and offer preponderance of "public benefits").

48 *See J.P. Morgan & Co.*, 75 Fed. Res. Bull. 192, 193 (1989) (indicating that five national bank holding companies have successfully petitioned Federal Reserve Board to be able to deal in various forms of debt and equity securities); Shafer, *supra* note 24, at 986 (1989) (stating that five bank holding companies including J.P. Morgan & Co. Inc., Chase Manhattan Corp., Bankers Trust New York, Citicorp, Security Pacific Corp. petitioned Federal Reserve Board requesting that their subsidiaries be allowed to underwrite in addition to dealing in debt as well as equity securities).

Consequently, the Federal Reserve Board allowed a significant amount of leeway in this area, resulting in vast litigation.[49]

Historically, the federal judiciary and the Federal Reserve Board have been extremely supportive of BHC's in their quest to expand their services to include greater amounts of securities activities.[50] Indeed, it is the BHC structure that enabled the unprecedented merger between Travelers Insurance and Citigroup.[51] The long-term viability of this combination, however, remains undetermined because the Act precludes the unrestricted combinations of commercial banking, insurance companies and investment banks that the merger promises.[52]

II. THE FINANCIAL SERVICES COMPETITIVENESS ACT (H.R.10)

The Financial Service Competitiveness Act of 1997,[53] proposed sweeping changes that would eradicate the Act's barriers preventing the integration of commerce and banking.[54] This new

49 *See Regulatory Reform, supra* note 11, at 552 (explaining that Glass-Steagall related litigation stems from tension created by differences in statutory language and administrative and judicial interpretation of broad Glass-Steagall provisions). *See generally* Donald C. Langewood, *Statutory Obsolescence and the Judicial Process: The Reverse Role of the Courts in Federal Banking Regulation*, 85 MICH L. REV. 672, 705 (1987) (noting that Glass-Steagall litigation has presented opportunity for Section 20 to be construed in way to weaken Glass-Steagall). *See, e.g.*, Securities Industry Assoc. v. Board of Governors, 468 U.S. 207, 207 (1984) (holding that holding companies were free to enter brokerage activities because strict reading of section 20 pertained to companies principally engaged in traditional distribution of securities).

50 *See Bankers Trust New York Corp.*, 75 Fed. Res. Bull. 829, 830 (1989) (noting that private placement of commercial paper by BHC nonbank subsidiary is not underwriting or deal for purposes of Glass-Steagall); *Regulatory Reform, supra* note 11, at 548 (explaining that regulatory agencies as well as federal courts have allowed significant expansion of bank securities power); *Feds Must Understand Risk, Risk Management*, CAP. MKT. REP. , Feb. 26, 1998, *available in* Westlaw at 2/26/98, Cap. Mkt. Rep. 19:32:00 (noting that Fed has been drawn into regulatory issues that arise out of bank expansion into securities transactions).

51 *See* Ron Chernow, *The Birth of a Bureaucratic Mastedon?*, WALL ST. J., Apr. 9, 1998, at A22 (explaining that Citicorp will be absorbed into Travelers, which will then apply to Federal Reserve Board for BHC status); McTague, *supra* note 10, at 20 (stating that merger is structured so Travelers acquires Citicorp and Travelers applies to Fed for bank charter and at such time, Fed has discretion to give new company up to five years to divest itself of impermissible nonbanking activities, such as securities underwriting).

52 *See* McTague, *supra* note 10, at 20 (stating that Travelers Group and Citicorp are gambling that Congress will finally rewrite Glass-Steagall Act, paving way for their merger en toto).

53 *See* H.R. 10, 104th Cong.(1997) (re-introduced in 1998 and 1999 sessions in substantially similar form); Steven Cocheo, *One More Time: With (BIF-SAIF) Behind Him House Banking Chief Jim Leach Has High Hopes for Bank Modernization*, ABA BANKING J. , Mar. 1, 1997, at 34 (explaining that securities affiliates would be permitted to engage in merchant banking).

54 *See* H.R. REP. NO. 105-164 II, at 4 (1997) (quoting sponsor James A. Leach that:

proposal allows commercial banks, securities firms and insurance companies to combine their services in a way that resembles European and Japanese systems, known as "universal banking."[55] This bill is Congress' attempt to reclaim the responsibility of deciding the status of the financial services industry from the courts and regulators.[56]

A. Fundamental Concepts of H.R. 10

The major provisions of H.R. 10 allow non-banking firms such as securities and insurance outfits to merge with commercial banks.[57] The bill would have allowed non-financial commercial firms to own small banks through a well-capitalized holding company and permit bank holding companies to own commercial firms,[58] subject to certain revenue limitations.[59] It also permits

"The bill would allow two approaches that would mix banking and commerce."); *Where's Wall Street? And Does It Matter?*, WALL ST. & TECH, Oct. 1, 1997, *available in* 1997 WL 13096712, *8-10 (noting that bill will allow banks to offer same services as securities firms and vice versa).

55 *See* Reinhold Leichtfuss & Fran Mettern, *Best Practices: What Retail Banks Can Learn From Each Other*, J. OF RETAIL BANKING SERV., Dec. 1, 1996, at 41 (describing how United States, Japanese, European banking systems are all evolving toward similarity); Dean Foust, *Opening the Door to Another Banking Crisis*, BUS. WK., June 23, 1997, at 156 (refuting argument of commentators who favor melding banking and commerce by stating that main reason for Japanese banks huge losses are loans to affiliated non-financial companies). *See, e.g.*, Dyan Machan & Peter Fuhrman et. al., *Finance Shokku* (Japanese Banking Industry), FORBES, Apr. 13, 1992, at 42 (describing Japanese interlocking shareholder system where among other things, manufacturing companies invest in bank stocks in return for cheap loans).

56 *See Bankers Trust Deal*, *supra* note 36, at *2 (discussing need for Congress to take lead in banking regulation); *Financial Services Restructuring: Views of Fleet Financial Group on H.R. 10, the "Financial Services Competitiveness Act of 1997" Before the House Subcomm. On Finance & Hazardous Materials of the Committee on Commerce*, 104th Cong., July 25, 1997, *available in* 1997 WL 446990, at *3 (statement of John P. Hamill, President, Fleet Bank) (explaining that Congress should pass H.R. 10 in order to promote rational and reasonable regulatory oversight).

57 *See* Kenneth Guenther, *IBAA Executive Vice President, Kenneth A. Guenther Sends Letter to Chairman of House Commerce Committee Regarding the Financial Services Competition Act*, PR NEWSWIRE, July 31, 1997, *available in* Westlaw, 7/31/97, PRN Newswire 13:01:00, at *3 (stating that H.R. 10 destroys barriers between banking and commerce by stretching Federal Deposit Insurance safety net to unintended areas by permitting commercial banks to integrate with securities firms, and also allowing commercial firms to integrate with banks); *IBAA: Controversial Banking Legislation Likely to Bring Higher Bank Fees*, PR NEWSWIRE, July 31, 1997, *available in* Westlaw, 7/31/97 PR Newswire, 14:20:00, at *1 (fearing higher bank fees, small businesses believe H.R. 10 will further concentrate financial industry); Katherine M. Reynolds, *House Panel Wraps Hearing on Financial Modernization Bill*, BOND BUYER, July 31, 1997, at 5 (discussing H.R. 10 and its allowance of banking, securities, and insurance institutions to own each other).

58 *See* H.R. REP. NO. 105-164, at 4 (1997). The "[b]ank holding companies could own commercial firms as long as the aggregate commercial revenues do not exceed fifteen percent of the holding companies' gross domestic revenues." *Id.* "It would also allow a

certain activities, whereby well-capitalized, well-managed, bank holding companies could own a "basket" of commercial firms.[60] The aggregate commercial revenues of such an institution, however, could not exceed fifteen percent of the holding company's gross domestic revenues.[61] Additionally, the "reverse basket" approach also allows a non-financial firm to control a bank holding company with one "small" commercial bank, whose assets could not total more than $500 million.[62] Furthermore, that "small" bank's revenues could not exceed 15 percent of the con-

commercial firm to control a bank holding company with one small bank (less than $500 million in assets)." *Id.*; *see also* Bill McConnell, *Leach: Keeps Banks and Non-Financial Firms Separate Series*: 10 AM. BANKER, Feb. 20, 1997, at 3. In a speech, Representative Leach stated that his legislation "would let investment bank holding companies put a small amount of non-financial assets in wholesale, uninsured financial institutions. . ." *Id.*; Katherine M. Reynolds, *House Commerce Committee Continues Modernization Talks Behind the Scenes*, BOND BUYER, Sept. 11, 1997, at 5. H.R. 10 will allow ". . .[b]anks, securities firms, and insurance companies to own one another and, to a limited degree, commercial companies could enter into the mix." *Id.*

59 *See Roukema Says Commerce Should Not Reserve Charter Conversion Debate*, 16 NO. 15 BANKING POL'Y REP. 5, Aug. 4, 1997, at *5 (stating that bill would allow holding companies to invest up to fifteen percent of gross revenue in commercial activities); *OCC is Critical of House Banking Committee Bill*, 16 NO. 4 BANKING POL'Y REP. 2, July 21, 1997, at 6 (explaining that if bank holding company is allowed to derive fifteen percent of its gross revenues from affiliations with non-financial, bank holding company will be subject to Federal Reserve Board oversight, but if non-financial company owns bank under reverse basket approach, parent company will not be subject to same federal standards).

60 *See* H.R. REP. NO. 105-164; Cocheo, *supra* note 53, at 34 (explaining that under holding company structure, banks could affiliate with securities firms and insurance companies, provided revenue limitations are adhered to).

61 *See Financial Services Restructuring, Address Before House Banking and Financial Services Committee*, June 3, 1997, *available in* 1997 WL 11233222, at *3 (statement of Jonathan D. Hawke, Treasury Undersecretary for Domestic Finance) (elaborating on financial requirements necessary to acquire bank holding company status); Guenther, *supra* note 57 (explaining that banks' ownership of commercial affiliate comprising fifteen percent of its gross domestic income is referred to as "basket"; and that corporation's ownership of small bank is referred to as "reverse basket"); *Bank Deregulation; Repeal of Glass- Steagall (H.R.10)*, BOND BUYER, June 24, 1997, at 5 (indicating that under H.R. 10, banks, securities firms, and insurance companies could merge with commercial companies as long as they do not exceed fifteen percent "basket" of financial companies gross revenues).

62 *See Financial Modernization, Testimony Before the House Subcommittee on Finance and Hazardous Materials Committee on Commerce*, July 17, 1997, *available in* 1997 WL 11235799, at *18 (testimony of Andrew C. Hove, Acting Chairman, FDIC). H.R. 10 also would allow a commercial firm to control a [qualified] bank holding company with one small bank, a bank with $500 million or less in assets, without the commercial firm becoming a bank holding company. *Id.*; *Comments on Recent OCC Circulars About H.R. 10, Before House Banking and Financial Services Committee*, July 24, 1997, *available in* 1997 WL 12101496, at *15 (testimony of Rep. James A. Leach). The reverse basket approach allows a commercial entity to own a bank with assets of over $500 million. *Id.* Katherine M. Reynolds, *Committee Wades Through Financial Modernization Bill*, BOND BUYER, June 19, 1997, at 5. House Banking Committee voted 25-23 to pass a reverse basket amendment which allows non-financial companies to obtain fifteen percent of their gross revenues from a bank with less than $500 million in assets. *Id.*

solidated gross domestic revenues of the commercial firm.[63]

B. *Preventative Measures*

Moreover, H.R. 10 includes so-called "firewalls."[64] These provisions purportedly protect the Federal Deposit Insurance Company ("FDIC") from having to undertake bailouts by prohibiting banks from lending depositors' insured funds to their commercial affiliate.[65] The effectiveness of these "firewalls" has been subject to much scrutiny.[66] It is the market, not regulations, that dictate the financial transactions between banks and their affiliates.[67] In addition, contagion risk is an often-cited failure of firewalls. Implicit in contagion risk theory is the notion that if a bank's non-financial venture needs an infusion of capital, the bank will find a way to lend needed funds to their subsidiary regardless of

63 H.R. REP. NO. 164 (II), 105th Cong. (1997), *available in* 1997 WL 584295, at *44 (noting revenue limitations of small banks under reverse basket approach of H.R. 10).

64 *See id.* at *8 (discussing firewall provision of H.R. 10 intended to protect bank components of financial services organization from other riskier activities); Steven D. Kaye et. al, *Megamerger One Stop Shopping is a Mixed Bag for Banking Consumers*, U.S. NEWS & WORLD REP., Apr. 20, 1998, at 62 (questioning whether it is safe for corps to have access to depositors funds during serious economic downturn, since instinctive reaction of corporation is survival and as such, it will use profitable units to subsidize other units in crisis).

65 *See* H. R. REP. NO. 105-164, at 6 (1997). "The bill would create 'firewalls' to protect the banking components of a financial services organization from its riskier securities, insurance, or other financial affiliates, hopefully preventing financial and informational abuses and conflicts of interest." *Id.*; *Financial Services Restructuring, Before the Committee on Banking and Financial Services*, 104th Cong., May 22, 1997, *available in* 1997 WL 10571950, at *34 (statement of Arthur Levitt, Chairman, SEC). "The commission generally supports the firewalls in H.R. 10 and H.R. 268 that would require a securities affiliate of a bank to make certain disclosures to its customers." *Id.* "For example, the bills would require disclosure that the securities being sold are not FDIC-insured, not bank deposits and not bank guaranteed." *Id.*; John R. Walter, *Firewalls*, ECONOMIC Q., Sept. 1, 1996, at 15. "Firewalls, limit, prohibit or set standards for transactions between banks and affiliated non-banking companies." *Id.*

66 *See Building a Firewall: Can It Work?*, AM. BANKER, Dec. 14, 1987, at 1 (stating that even proponents of Glass-Steagall reform admit that firewalls do not provide security, especially in troubled times); Helen A. Garten, *Subtle Hazards, Financial Risks and Diversified Banks: An Essay on the Perils of Regulatory Reform*, 49 MD. L. REV. 314, 380 (1990) (stating that management has variety of ways to evade firewall restrictions, thereby eliminating their effectiveness); Roberts, *supra* note 42, at 285 (stating that firewalls do not generally work in times of crises because capital can easily be moved when needed).

67 *See* William M. Aukamp, *Mixing Banking and Commerce: Beware!*, U.S. BANKER, June 1,1997, at 73. "Firewalls and other legal safeguards aside, when under pressure from superiors in an organization some individuals will not risk their careers by refusing to act as directed." *Id.*; *Rep. Markey Rejects Bank Commerce Plan, But Still Open on Affiliations Provisions*, BNA BANKING DAILY, Aug. 1, 1991, at 2. "No matter what the written rule and stated intentions, I believe that commercial pressure will burst through firewalls despite our best intentions, if we put major corporations in charge of banks". *Id.*

any prohibitions against such an arrangement.[68]

C. *Wholesale Financial Institutions*

H.R. 10 also proposed to create a new type of bank: Wholesale Financial Institution ("Woofies").[69] Woofies are banks that are regulated by BHC restrictions and are not able to accept insured deposits or deposits less than $100,000.[70] Holding companies with a Woofie and no federally insured depository institution would have greater flexibility to engage in non-financial investments.[71] Woofies do not interact with insured deposits and, as a result, would not require any federal bailout should speculative business practices impair investments.[72] As such, it is asserted that Woofies do not pose the same problems as the basket approaches.

III. DESTROYING THE BARRIER BETWEEN BANKING AND COMMERCE WILL CREATE ANOTHER BANKING CRISIS

Significant problems will arise where a bank utilizes the basket approach to purchase a non-financial interest or a corporation employs the reverse basket approach to purchase a small bank.[73] The authors submit that past experiences in industries

68 *See* Paul Tannenbaum, *Banking Reform Proposals*, 63 U.COLO. L. REV. 811, 827 (1992) (stating that due to market pressures, it is highly improbable that bank would not come to rescue of failing subsidiary of its holding company.); *Through a Glass Darkly (Glass-Steagall Act of 1933, Separating Commercial Banks and Investment Banks was Unnecessary Then and Now)*, ECONOMIST, Feb. 19, 1994, at 92 (stating that some initial pro-Glass-Steagall arguments centered on the concern that if bank was owed money by failing company, it would sell securities to unsuspecting public in effort to clear debt).

69 *See* H.R. REP. NO. 105-164, at 2 (defining parameters of Wholesale Financial Institution).

70 *See id.* at 21 (stating that such non-banks would be required to comply with bank holding company restrictions pursuant to Bank Bolding Company Act as well as Community Reinvestment Act).

71 *See id.* at 22 (stating that holding company which only has Woofies, with no federally insured deposits, will be afforded greater flexibility in form of larger basket for commercial investment).

72 *See Statement on Changes in Banking Bill Before the Financial Services Council*, Government Press Release, Dec. 17, 1996, *available in* 1996 WL 11126511, at *12 (statement of Rep. James A. Leach, Chairman, House Committee of Banking and Financial Services) (stating that restrictions placed on Woofies will create entity that does not pose threat to Federal Deposit Insurance Company). *See generally* H.R. REP. NO. 105-164 II, 21-22.

73 *See* Henry B. Gonzalez, *Views of Representative Henry B. Gonzalez (D-San-Antonio, Tex.)* (visited October 27, 1997) <http://www.house.gov/banking/addvgonz.htm> (describing reverse basket provision as "very risky and dangerous step to take"); Miles Moore, *NTDRA Among Many Groups Opposing Banking Reform Bill*, TIRE BUS., Oct. 13,

and countries permitting such interaction between banking and commerce have demonstrated the potential disaster surrounding such financial practices.[74]

A. *Forseeable Risks*

In *Investment Company Inst. v. Camp*,[75] the Supreme Court foresaw two major risks in mixing banking and commerce.[76] First, the Court stated that banks might invest their assets in imprudent stocks or securities.[77] Second, it foretold the likelihood that banks would make unsound loans to subsidiaries to avoid losing public confidence in those affiliates.[78]

Critics of the *Camp* court, on the other hand, have assailed this logic by contending that a rational bank would neither engage in the economically unsound behavior of selling overpriced securities or make unsound loans to subsidiaries.[79] Further-

1997, at 18 (quoting from letter that coalition of business groups sent to Rep. Thomas Bliley, Chairman of the House Commerce Committee, opposing H.R. 10.) (stating that "[p]ermitting commercial banks to merge with commercial firms would be bad public policy and steer our nation down a perilous economic course"); *see also* Guenther, *supra* note 57, at *1 (declaring that mixing of commerce and banking will lead to dangerous concentration of economic assets, while also jeopardizing impartial allocation of credit, reducing competition, shrinking number of institutions in consumer market place).

74 *See* Kaye & Egan, *supra* note 4, at 60-62 (reiterating that combination of banking and non-banking firms places nation's financial system in danger and emphasizing that marriage of brokers and banking created S&L crisis).

75 401 U.S. 617 (1971).

76 *See* Investment Company Inst. v. Camp, 401 U.S. 617, 628 (1971) (illustrating foreseeable risks associated with mixing banking and commerce); Jonathan R. Macey, *Special Interest Group Legislation and The Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1, 6 (1984) (arguing that banks may make inherently risky investments without prevention mechanisms).

77 *See Camp*, 401 U.S. at 628.

78 *See id.* at 630-36. The Court was mainly concerned that hazards arising from banks' public identification with their securities affiliates and the corresponding effect of the public's perception of banks' viability would precipitate conflicts of interest. *Id.* at 630. In addition, the Court cautioned against the possibility that banks would extend credit imprudently. *Id.* at 631. Further the Court warned that depositors may not recognize the risks involved with investing in the banks' security affiliates by mistakenly assuming that they are as secure as bank deposits. *Id.* at 630; *see also* Brown, *supra* note 7, at 133-134. Banks are susceptible to making uninformed decisions when the well-being and credibility of their subsidiary is at stake. *Id.*

79 *See* Brown, *supra* note 6, at 134 (arguing that banks will not sell speculative securities or make improper loans to affiliates). *See generally* Peter J. Ferrara, *The Regulatory Separation of Banking From Securities and Commerce in the Modern Financial Marketplace*, 33 ARIZ. L. REV. 583, 593 (1991) (asserting that maintaining separation between banking and securities activities is both difficult and impractical); Daniel R. Fischel & Andrew M. Rosenfield et. al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 326 (1987) (stating that banks would have no incentive to subsidize "troubled" affiliate).

more, critics claim that good management skills and sound business practice would ensure the prosperity of banks.[80]

However, the following examples demonstrate that the *Camp* Court's concerns; indeed, banking and corporate executives cannot always be relied upon to be prudent decision makers. In the three decades since *Camp*, the United States government and its European and Asian counterparts have been forced to bail-out failed lending institutions because customers' deposits were used to engage in failed speculative transactions.[81] In general, the lenders had virtually no experience with the individual ventures, and no way to assess the reliability of loan repayment or return on their investments.[82] These unsound practices have given rise to several financial crises from which important lessons must be learned.

B. Financial Problems Abroad: The Jusen Crisis and Credit Lyonnais

The Jusen Crisis, which nearly toppled the prestigious Japanese Ministry of Finance,[83] epitomized the inherent danger of

80 *See* Brown, *supra* note 6, at 134 (stating that commentators who espouse risk-based conventional argument fail to realize that foreign banks have been able to minimize risks associated with corporate underwriting by prudently limiting risks).

81 *See* Steven Butler, *Better Late than Never, Japan Finally Moves to Clean Up Its Banking Mess, But There's a Lot More to be Done*, U.S. NEWS & WORLD REP., Oct. 26, 1998, at 53 (detailing how Japanese lawmakers voted to allocate $508 billion of taxpayer money to support sagging banks); Gail E. Edmondson, *This Time, the Bailout May Work, A State Rescue Will Force Credit Lyonnais to Sell Off Its Assets*, BUS. WK., May 25, 1998, at 50 (noting that French government has rescued Lyonnais three times in past five years because of mismanagement and incompetence); William Pesek, Jr., *Citigroup: Too Big to Fail? Fed Staffers Signal Reviving Fear of an Overheating Economy*, BARRON'S, Apr. 13, 1998 (noting how federal regulators were forced to bail out Continental Illinois by funneling $4.5 billion into bank to avoid worst failure since Great Depression); Neil Weinberg, *In the Name of the Common Good, the Japanese People Have Come to Accept a System that is Inimical to Their Best Interests*, FORBES, Nov. 16, 1998, at 22 (noting how Japanese Ministry of Finance has vowed to save all large banks, rather than liquidate them, in same fashion as U.S. government did during the S & L crisis).

82 *See* Justin Fox, *Why Japan Won't Budge: Everyone Wants Japan to Save Asia by Gunning Its Economy*, FORTUNE, Sept. 17, 1998, at 82 (blaming Japanese bank crisis on haphazard granting of excess credit in speculative ventures); *Conspiracy Theories*, ECONOMIST, Jan. 29, 1994, at 84 (discussing how S & L owners lent money for risky investments that proved to be long term losers).

83 *See* Edward W. Desmond, *How the Mighty Have Fallen; Once the Engine of Japan's Economy, the Elite Finance Ministry is Facing Unprecedented Attacks on Its Competence and Power*, TIME INT'L, Feb. 19, 1996, *available in* 1996 WL 8824767, at *12 (describing how series of embarrassing scandals surrounding jusen crisis has caused seemingly infallible Ministry of Finance to fall from grace); Curtis J. Milhaupt & Geoffrey P. Miller, *Japanese Financial Regulation as Seen From the "Jusen Problem"* 26 (1997) (unpublished manuscript on file with authors) (stating that Ministry of Finance

mixing banking and commerce.[84] As a result of the crisis, leading Japanese banks have suffered tremendous financial losses on their non-financial ventures.[85]

The crisis was sparked when seven jusen, or housing-loan companies, funded by Japan's largest banks and agricultural cooperatives, went bankrupt.[86] The jusen had extended credit to real estate companies with poor performance records, who in turn engaged in speculative transactions.[87] Moreover, the lending practices of the jusen management, characterized as "blatantly sloppy" and "irresponsible,"[88] resulted in billions of dollars in bad loans[89] that the Ministry of Finance was eventu-

lost much credibility because of erroneous estimation of non-performing loans by Japanese financial institutions as well as perception that it would jeopardize strong financial institutions by acquisition of failing institutions).

84 *See* Milhaupt & Miller, *supra* note 83, at 19-21 (stating that financial liberalization, lack of regulatory oversight, speculative lending and bubble economy combined to create jusen crisis); Desmond, *supra* note 83, at *4 (stating that government report certified inadequate lending practices by jusen administrators); Douglas Ostrom, *Tax Payer Tab Rises for Jusen Bailout*, JEI REP., Feb. 2, 1996, *available in* 1996 WL 8315842, at *2 (stating that Cabinet at Ministry of Finance signed off on plan to cope with secondary losses absorbed by new jusen rescue organization when it acquires $68 billion in bad loan debt from jusens).

85 *See* Edward W. Desmond, *Japan's Trillion-Dollar Hole That is Making Wall Street Nervous*, TIME, Apr. 8, 1996, *available in* 1996 WL 8825102, at *3 (stating that 21 of Japan's top banks wrote off $106 billion in bad loans as result of jusen scandal); *Takugen Failure Erodes Credibility of Japanese Banks Abroad*, TOKYO FIN. WIRE, Nov. 20, 1997, *available in* 1997 WL 7745166, at *1 (noting widespread uneasiness in U.S. as result of another major Japanese bank failure); Don Bauder, *U.S. Presses Japan to Spur Economy Through Fiscal Policy*, S. D. UNION TRIB., Nov. 14, 1997, *available in* 1997 WL 14534480, at *2 (discussing letter sent by U.S. Treasury Secretary Robert Rubin to Japanese counterpart urging country to repair perilous condition of its ailing banks); *Asian Currencies Weaken on Lingering Japanese and South Korean Concerns*, AGENCE-FRANCE-PRESSE, Nov. 26, 1997, *available in* 1997 WL 13442113, at *2 (stating that Japanese finance minister acknowledges need to curtail successive spread of bank failures).

86 *See* Peter C. DuBois, *Salvos Over Proposed Jusen Liquidation Signal Japan's Efforts to Reform*, BARRON'S, Mar. 4, 1996, *available in* 1996 WL Barron's 2813, at *302 (stating bankruptcy of jusen is major part of Japan's banking problems).

87 *See* Milhaupt & Miller, *supra* note 83, at 19-21 (stating that financial liberalization, lack of regulatory oversight in addition to speculative lending and bubble economy combined to create jusen crisis); *Action Over Bad Loan Problem*, ASIAN BANKER, Oct. 1, 1995, *available in* 1995 WL 14385117, at *1 (noting that jusens' bad loans led to major bailout by Japanese government).

88 *See* Desmond, *supra* note 83, at *12 (stating that government report certified inadequate lending practices by jusen administrators); Toshio Aritake, *Japan: MOF Panel Fails to Deliver Proposal*, BNA BANKING DAILY, Dec. 18, 1995, at D6 (discussing banks' inadequate risk management as one cause of jusen crisis); Toshio Aritake, *Japan Announces Plan for Cleaning Banks' Housing Loan Debts*, BNA INT'L BUS. & FIN. DAILY, Dec. 20, 1995, at D6 (contending that 30% of jusen loans went to gangsters making them "money of no return").

89 *See Jusen Debtor Bankruptcies Reach 147 in Japan: Survey*, ASIA PULSE, June 16, 1997, *available in* 1997 WL 10658211, *1 (reporting that jusen debts totaled approximately 1 trillion yen).

ally forced to underwrite.[90]

The jusen crisis was not an isolated incident in Japan.[91] Currently, private analysts place Japanese banks' bad debt from other unrelated real estate loans of hundreds of billions of dollars.[92] Furthermore, the credit ratings of some of Japan's prominent banks are rapidly deteriorating.[93]

Some proponents of financial modernization and deregulation assert that the differences between the U.S. and Asian banking practices make comparison of the different systems misleading.[94] Opponents of financial modernization and H.R. 10, however, argue that there are enough similarities to convince Congress to maintain a separation between banking and commerce[95] and to prevent banks from using insured deposits to engage in speculative transactions.

Another infamous example of the damage caused by misman-

90 *See* Ostrom, *supra* note 84, at *3 (stating that Cabinet at Ministry of Finance signed off on plan to cope with secondary losses absorbed by new jusen rescue organization when it acquires $68 billion in bad loan debt from jusens); *Tokyo's Big Sputter*, ASIAN WALL ST. J., Jan. 8, 1997, at 8 (stating that bailout of jusen by Ministry of Finance was only step in reformation of Japan's banking industry).

91 *See* Desmond, *supra* note 83, at *2 (stating that Ministry of Finance has assessed official bad debt of entire Japanese financial system to be $349 billion, however, according to experts actual debt may reach $1 trillion); Randall W. Forsyth, *Take a Good Look At Greenspan's Face, You'll See His Smile Looks Out of Place*, BARRON'S, Nov. 17, 1997, *available in* 1997 WL 15581360, at *3 (contending that Japanese authorities were bailing out big banks as well as jusen and that Japan's entire economy has suffered as result of bailouts); Todd Cromwell & Assif Shameen, *Reviewing the Banks: As Japan's Financial Sector Opens Up, Some Hard Decisions Ahead*, ASIA WEEK, May 2, 1997, *available in* 1997 WL 10819100, at *7-8 (asserting that restructuring of banks in Japan stems from faltering banks and bad loans).

92 *See* Donald R. Ciandella, *Cargill Unit Prepares to Sweep Into Japanese Property Market*, ASIAN WALL ST. J., Aug. 22, 1997, at 3 (explaining that seven year downturn in real estate market has caused Japanese banks to be saddled with at least $300 billion in bad real estate loans).

93 *See* Houtan Bassiri, *Analysts are Skeptical of Japan Bank Plan*, ASIAN WALL ST. J., Mar. 6, 1998, *available in* WL-WSJA 3471553, at *3 (noting that Moody's Investor's Service has significant concerns about asset quality and earnings of Japanese banks); David Thomas, *Japanese Decline Likely to Continue Despite $330 Billion Bailout*, FIN. POST, Mar. 6, 1998, *available in* 1998 WL 10755408, *4 (explaining that Moody's downgraded credit rating of several Japanese banks and plans to do same for more, noting that outlook for many banks has fallen from "stable" to "negative").

94 *See Finance Service Restructuring: Hearing on Financial Restructuring Before the House Commitee on Banking and Financial Services*, 105th Cong. (1997), *available in* 1997 WL 1057122, at *1 (statement of Bill Sones, President and CEO, State Bank and Trust Co.) (noting difference between U.S. and Japanese banking systems and stating that U.S. model is superior).

95 *See* Molly Ivins, *No Checks on Bank Shenanigans*, STAR LEDGER (Newark), Apr. 20, 1998, *available in* 1998 WL 3408422, at *3 (stating that Paul Volcker, former chairman of the Federal Reserve Board, argued that Asian Bank's reliance on mixing commerce and banking is one of main criticisms of their financial system).

agement in a mixed commerce and banking system is the failure and subsequent bailout of the French bank, Credit Lyonnais ("Lyonnais").[96] In that situation, the bank used deposits to invest in foolish and costly non-banking ventures that included the acquisition of two ailing companies, M.G.M Studios and Club Med Vacation Resorts.[97] As a result, Lyonnais received a $27 billion bailout from the French government by 1995.[98] Subsequently, the government company created to finance the sale of Lyonnais' surviving assets required an additional $1.4 billion to balance its books in 1996. In the end, Lyonnais benefited from three government bailouts while the French taxpayers bore the brunt of Lyonnais' imprudent investments.[99]

96 *See* Bill Javetski & Mia Trinephi, *A $27 Billion Rescue - and It May Not Be the Last*, BUS. WK., Apr. 3, 1995, at 50 (stating that cause of Lyonnais failure was due to problematic real estate loans, bad equities holdings and unprofitable business ventures); *see also Credit Lyonnais Arm Hire Lazard Freres to Study Sale of MGM*, WALL ST. J., Nov. 22, 1995, at B6 (stating that Credit Lyonnais took control of MGM in 1992 after years of huge losses on its loans to studio); Lisa Gubernick & Mara Matzer, *The Lion Roars: Poor Old MGM, Once the Proudest Name in Hollywood is Showing Signs of Life Again*, FORBES, Nov. 20, 1995, *available in* 1995 WL 8102775, at *2 (stating that Credit Lyonnais acquired MGM after studio defaulted on its loans).

97 *See Exor to Boost Club Med Stake*, WALL ST. J., Sept. 27, 1995, at A11 (reporting that Lyonnais sold its 5.42 percent holding in Club Med to Exor SA, French investment arm of Italy's Agnelli family); Fred Kapner, *France's Credit Lyonnais Met Target to Sell 1.86 Billion in Assets in 1994*, WALL ST. J., Jan. 4, 1995, at A7 (reporting that bank may reduce 5% shareholding in Club Mediteranee SA); Stewart Toy, *Can Anyone Fix France? The Next President's Herculean Task*, BUS. WK., May 8, 1995, at 46 (contending that reasons for Lyonnais' decline focused on taking of foolish stakes in French companies and making politically motivated bad loans); *Troubled French Bank Concedes More Job Cuts Needed*, ASSOC. PRESS, Jan. 17, 1997, *available in* 1997 WL 4852240, at *2 (reporting that bank expanded too rapidly in 1980s, notably in ill-fated movie, industrial and real estate ventures); Alan R. Katz, *Strauss-Kahn, EU's Van Miert Meet Monday on Credit Lyonnais*, DOW JONES NEWS SERV., Jan. 14, 1998, *available in* Westlaw, 1/14/98 DJNS 09:33:00, at *2 (explaining that Credit Lyonnais has been assisted by France since its expansion in 1980s left it with "mountain of bad or questionable outstanding loans").

98 *See* Jay Branegan, *Staying Afloat—Barely the Worst May Be Over for France's Disaster-Struck Banks, But They Still Face Ruinous Competition*, TIME INT'L, June 17, 1996, *available in* 1996 WL 10668076, at 3-4 (stating that French government had to spend $27 billion to bail out Credit Lyonnais, previously world's largest non-Japanese bank); Nathaniel C. Nash, *France Offers Plan to Bail Out Credit Lyonnais for $27 Billion*, N.Y. TIMES, Mar. 18, 1995, at A5 (detailing of largest single bank bailout in history); Douglass Lavin, *French Bank Turns Up Heat on Lyonnais*, WALL ST. J. EUR., Mar. 28, 1995, *available in* 1995 WL WSJE 2146835, at *13 (noting issuance of blistering critique of France's multi-billion dollar bailout of Credit Lyonnais).

99 *See* Bill Javetski, *The Legacy of Lyonnais: Debts and Doubts*, BUS. WK., May 8, 1995, at 20 (stating that government company established to bail out Credit Lyonnais needs $1.4 billion in public funds to balance its own books, underscoring notion that French tax-payers must bear brunt of Lyonnais debacle); *see also* Charles Flemming, *Credit Lyonnais Shares Soar 6.5%*, WALL ST. J., EUR., June 25, 1997, at 2 (reporting that French agency, Public Establishment for Finance and Restructuring, needed additional public funds to cover finance costs of holding company established to oversee sell-off of Lyonnais' bad assets); *France Outlines Reforms to Sales of Lyonnais Assets*, AP-DOW JONES NEWS SERV., Dec. 17, 1997, *available in* 1997 WL-WSJE 12217511 (reporting that

C. Domestic Financial Crises: Lessons of the Savings and Loan Scandal

The Savings and Loan ("S&L") failures created a financial crisis unseen in the United States since the Great Depression and demonstrate dangers inherent in deregulating financial institutions and permitting the combination of commerce and banking.[100] Although many attribute the well-publicized criminal acts of thrift managers as the cause of the S&L crisis, only about ten to fifteen percent of the S&L scandal was actually a result of fraud or mismanagement.[101] Many commentators agree the crisis was precipitated by risky, albeit legal behavior made possible by loopholes created by Congress in an attempt to rejuvenate the S&L industry.[102]

state run entity formed to bail out Lyonnais was forced to reform due to losses).

100 *See* Benjamin J. Stein, *Without Glass-Steagall, History will Repeat*, BARRON'S, Feb. 4, 1991, at 16. Stein argues that:

> We have a daily spreading S&L disaster that happened when we forgot that testimony and repealed Glass-Steagall for S&Ls. 'What is past is prologue,' says an inscription in front of the National Archives, about a quarter mile from the main office of the SEC. We have the past available to us, but if investors and their representatives are alert, it need not be prologue again. Or, it can be prologue indeed, to new fraud, new ways for people in securities business to have another go at their captive trustors, laughing up their sleeves behind words like 'Chinese Walls' and 'Insulated Firewalls.' History is a nightmare from which we should at least make a stab at escaping, especially when all it takes is to leave the law as it is.

Id.; *see also* Michael Schroeder, *It's Alive: Why Glass-Steagall Reviled for Decades, Just Won't Go Away*, WALL ST. J., at A1. President Reagan's efforts to repeal Glass-Steagall were stymied by the S&L crisis. *Id.*; Marc J. Epstein, *Accountants and the S & L Crisis*, MGMNT. ACCT. (USA), Feb. 1, 1993, at 24 (stating that S & L debacle has been costliest financial disaster in United States history); Richard W. Stevenson, *Spotlight on S & L Crisis Over, But Bailout Tab Still Remains*, ORANGE COUNTY REG., Mar. 20, 1996, *available in* 1996 WL 7017807, at *1 (describing scope of S & L crisis and its ramifications on United States' economy).

101 *See Bank Insider Activities: Insider Problems and Violations Indicate Broader Management Deficiencies*, *available in* Westlaw, GAO/GGD 94-88 (1994), at *31-49 (by James Bothwell, Director of Financial Institutions & Market Issues). Congress requested a study to be conducted by the GAO, which revealed that in a study of failed banks between 1990 and 1991, investigators discovered that only a quarter of bank failures were attributed to fraud. *Id.* While mismanagement, including insider loans created the most instability within the organizations. *Id.*; *see also* James Flanigan, *Listen Well to Greenspan's Warning Words*, L.A. TIMES, Dec. 8, 1996, at D1. Renewed exuberance of investors and their search for high yield investments should be tempered with caution. *Id.* Additionally, he contends that it was the search for this type of yield that led to difficulties in the S&L industry and that this was compounded by mistaken policies and dishonesty in government. *Id.*; Michelle Singletary, *Justice Department Hails Prosecution at Bank, S & L's; Report Says 3700 Senior Executives, Owners of Failed Thrifts Have Been Sent to Prison*, Nov. 14, 1995, *available in* 1995 WL 9272306, at *3. Mismanagement by S & L's, rather than criminality, was the main cause of the crisis.

102 *See* John Grogan, *Savings and Loan Crisis Catches Investors in its Web*, SUN SENTINEL, June 23, 1996, at A10 (discussing how actions taken by Congress in early 1980's designed to fuel growth of S&L's ultimately led to crisis); Franklin E. Zimring &

In the 1980's, Congress passed several laws that essentially deregulated the entire savings and loan industry[103] in an attempt to galvanize investments in S&L thrifts in an era of high inflation. In particular, the Garn St. Germain Act ("GSA")[104] allowed thrifts to diversify their investment portfolios to include ventures other than traditional home loans.[105] S&L managers took advantage of the provisions of the GSA, and used deposits insured up to $100,000 dollars[106] to enter into risky transactions in areas in which they were inexperienced, including real estate development ventures, construction and management of resort hotels and buying and raising thoroughbred horses.[107]

Eventually, according to Senator Phil Graham, "a whole series of dominoes began to fall;" the 1986 tax reform act eliminated investors' incentive to invest in real estate and the crash in oil

Gordon Hawkins, *Crime, Justice and the Savings and Loan Crisis*, 18 CRIME & JUST. 247, 270 (1993) (discussing how S & L crisis is attributed to various factors, including deregulation of thrifts and subsequent changes to minimum capital requirement).

103 *See* Steven V. Robert & Gary Cohen, *Villians of the S&L Crisis Since the Mid-Seventies, Many Officials Have Been Part of the Cover-up*, U.S. NEWS AND WORLD REP., Oct. 1, 1990, *available in* 1990 WL 3578256, at *7 (stating that President Reagan and Vice-President Bush ushered in de-regulating campaign which allowed thrifts to implement series of accounting changes that allowed them to hide their growing insolvency while diminishing system's integrity); *Conspiracy Theories (Collapse of Savings and Loan Institutions)*, ECONOMIST, Jan. 29, 1994, *available in* 1994 WL 1275763, at *3 (discussing how easing of accounting rules allowed S & L's to boost initial profits but incur undetectable long term liabilities); *see also* Alan S. Blinder, *The Bank Crisis and the S & L Fiasco; Two Sides of a Bad Coin*, BUS. WK., Feb. 4, 1991, *available in* 1991 WL 2056043, at *2 (discussing how Congress, in seeking to save then dying S & L industry, eased regulations which allowed for abuses).

104 *See* Garn-St. Germain Depository Institutions Act of 1982, Pub. L. No. 97-320, 96 Stat. 1469 (codified in scattered sections of 23 USCA); Robert & Cohen, *supra* note 103, at 8 (stating that purpose of Act was to "[l]et S&L's expand beyond the home-building business, and permit them to invest in more high-risk, high return ventures;" further noting that Senators reflecting upon act stated "this made sense in theory but it became a critical step on the road to financial ruin"); *see also* Mark D. Wallace, *Life in the Boardroom After FIRREA: A Revisionist Approach to Corporate Insured Depository Institutions*, 46 U. MIAMI L. REV. 1187, 1256 (1992) (noting that Garn St. Germain Act laid foundation for decimation of thrift industry as managers, no longer restrained by separation of banking and commerce, were able to engage in super optimal risk taking, gambling on the resurrection of industry with backing of deposit insurance).

105 *See Will Charlie Keating Ride Again? Congress is Once Again Looking at Banking Deregulation. Will it Ignore the Lessons of the Past? (Charles H. Keating Jr. and the Lincoln Savings and Loan Scandals of the 1980's)*, WASH. MONTHLY, Mar. 1, 1997 (stating Garn St. Germain Act "deregulated thrift industry and threw wide open the doors of the S&L's to anyone with a plausible story, a fistful of cash, and a visible desire to start doing all sorts of wonderful and imaginative things with tax-payer deposits")

106 *See* Grogan, *supra* note 102, at A10 (discussing how thrift managers took advantage of deregulation by investing in speculative real estate ventures).

107 *See* James Sterngold, *Crisis?, What Crisis?*, SAN ANTONIO EXPRESS, Dec. 15, 1996, *available in* 1996 WL 11511924, at *4 (stating that Congress allowed thrifts to engage in businesses which were unfamiliar to them such as real estate, hotels and race horses).

prices in Texas and Oklahoma plunged the S&L industry into crisis.[108] Declining land values combined with mass speculation forced the U.S. government to spend between $90 and $180 billion to bail out failed S&L's.[109]

In the mid-1980's, the United States averted another financial disaster when the government bailed out Continental Bank of Illinois.[110] Consumers lost confidence in Continental because of bad loans[111] made by the bank, which precipitated bank customers to demand repayment of their deposits.[112]

At the time of the bailout, deposit insurance was capped at $100,000 per depositor.[113] In this instance, however, the FDIC extended protection to deposits exceeding $100,000, in order to protect the bank.[114] The FDIC argued that this extension was a

108 *See* Grogan, *supra* note 102, at A10 (detailing downward spiral leading to S & L industry downfall); Jerry Kammer, *Keating Wins Battle Over Verdict, is Granted a Hearing on Federal Conviction*, ARIZ. REP., June 22, 1996, at A1 (stating that de-regulation of industry allowed savings and loans to use their federally insured deposits in risky investments including commercial real-estate, junk bonds and currency futures); *see also* Stuart Auerbach, *Panel Calls for Overhaul of S & L Regulation*, WASH. POST, July 28, 1993, at D3 (describing how federally insured deposits were "fundamental condition necessary for the S & L crisis because it attracted investors to S & L's with hope of large returns on investments with little risk).

109 *See* Grogan, *supra* note 102, at 10A (stating that total cost to tax payers after sell off all assets was $90 billion); Eric Schurenberg, & Miriam Leuchter, et. al., *The S & L Black Hole - How It Will Suck You In*, MONEY, July 1, 1990, at 68 (stating that total bailout of S & L crisis could total $500 billion over thirty years).

110 *See* Foust, *supra* note 55, at 156 (stating that regulators were forced to rescue Continental Bank due to bank's funding of non-financial ventures).

111 *See Continental Illinois Through Worst of Mess*, S. D. UNION TRIB., Sept. 11, 1984, at A17 (noting Continental's problems started with acquisition of bad energy loans from failing neighbor bank, with whom it had questionable ties); *Continental Settles Suit By Shareholders*, NEWSDAY, Nov. 26, 1986, at 53 (discussing how Continental purchased energy loan which depreciated when oil market went into tail spin).

112 *See* Thomas E. Lange, *The Merger of Banking and Insurance: Will Congress Close the South Dakota Loophole?*, 60 NOTRE DAME L. REV. 762, 778 n.83 (1985) (explaining that run on Continental deposits began when investors believed rumors that Continental would fail, as it was unable to sustain large increases in problem loans); *see also* Albert J. Boro, Jr., *Banking Disclosure Regimes For Regulating Speculative Behavior*, 74 CALIF. L. REV. 431, 490 n.54 (1986) (noting that bailout was due to uninsured depositors withdrawing $10 billion in two month period in 1984); Mark O. Rollinger, *Interstate Banking and Branching Under the Riegle Neal Act of 1994*, 33 HARV. J. ON LEGIS. 183, 223 (1996) (explaining that Continental's huge write-off of loans led to run on deposits).

113 *See* William A. Lovett, *Moral Hazard, Bank Supervision and Risk Based Capital Requirements*, 49 OHIO ST. L. J. 1365, 1393 (1989) (noting that FDIC insurance protection at time of Continental bailout was $100,000 per depositor); David Andrew Segal, *A Note to Congress and the FDIC: After FIRREA, Where's the BIF?*, 59 FORDHAM L. REV. 5411, 5435 (1991) (noting that regulators exceeded $100,000 depositor insurance with 1984 bailout of Continental).

114 *See A Financial Horror Story (Bank Deposits Insurance Programs Offered by Governments)*, ECONOMIST, Apr. 27, 1996, at S17 (stating that when Continental Bank went under in 1984, FDIC protected all depositors, regardless of size of deposit amount); Jonathan Macy & Geoffrey P. Miller, *Bank Failures, Risk Monitoring and the Market For*

measure undertaken to prevent panic among bank depositors at other institutions who feared for the safety of their deposits, could therefore have caused similar crises at other banks.[115]

D. H.R. 10 Poses Significant Risks to the Banking Industry and the American Public

The passage of H.R. 10, with its provisions allowing the combination of banking and commerce, undermines the stability of the financial industry.[116] Experiences in various parts of the world and in the United States exemplify the risk that the combination of banking and commerce poses.[117] The American S&L crisis and Continental bailouts, the jusen crisis in Japan and the debacle involving Credit Lyonnais in France, were all caused by banks entering into imprudent commercial ventures.[118] Another feature shared by these banks is that their respective governments bailed them out when their investments failed, at the expense of the taxpaying public; a prospect that U.S. citizens might be faced with upon passage of H.R. 10.[119]

Bank Control, 88 COLUM. L. REV. 1153, 1180 (1988) (discussing Continental bailout and how it protected all of bank's deposits and general creditors from loss).

115 *See* Beth Kobliner, *How to Protect Yourself in the Bank Crisis (Loan Agreements, Rating Service, Federally Insured Institution)*, MONEY, Mar. 1, 1991, at 112 (stating that need to bail out Continental's depositors in totality arose from desire to prevent similar deleterious effects at other banks); Jonathan R. Macy & Elizabeth Garret, *Market Discipline By Depositors: A Summary of Theoretical and Empirical Arguments*, 5 YALE J. ON REG. 215, 236 (1988) (discussing how bailout of Continental sent message to uninsured depositors that regulators would not let banks fail).

116 See *Financial Modernization: Hearing on Financial Services Act of 1998 (H.R. 10) Before Senate Comm. On Banking, Housing and Urban Affairs*, 105th Cong. (1998), *available in* 1998 WL 375030, at *4 (statement of William L. McQuillan, President, Independent Bankers Association of America) (stating that concern with H.R. 10 is that it should not encourage common ownership of commercial banks and commercial firms at time when Japan and Asia are struggling with enormous economic and financial crises fueled by such "crony capitalism").

117 *Financial Services Restructuring, Before the House Committee on Banking and Financial Services*, 104th Cong. (1997) (testimony of Paul A. Volcker, Chairman, Jason D. Wolfesohn, Inc.) *available in* 1997 WL 251124, at *9 (stating that "there is plenty of recent experience in other parts of the world to suggest the potential problems with banking/commerce links are not theoretical").

118 *See* Milhaupt & Miller, *supra* note 83, at 18-19 (discussing speculative ventures entered into by jusen); Sterngold, *supra* note 107, at 4 (asserting that S & L's were jeopardized by entering into risky transactions in areas where managers had no experience); *see also* Javetski & Trinephi, *supra* note 96, at 50 (stating that cause of Lyonnais failure was problematic real estate loans and non-profitable business investments).

119 *See Financial Modernization*, *supra* note 116, at *9 (noting that further IBAA concern is that ongoing mergers and acquisitions are establishing "too-big-to-fail" entities posing systematic risks to financial system and economy, which future administrations or regulators will always bailout if problems arise).

These Financial debacles were made possible by inadequate supervision by government regulators and imprudent lending by banks permitted to speculate in commercial ventures.[120] The safeguards provided by H.R. 10 are not strong enough to prevent the abuses that fueled these recent financial disasters.[121] The firewall provisions that are designed to protect against imprudent loans between banks and their commercial affiliates have been attacked as unworkable and un-realistic.[122] Further, the basket structure of H.R. 10, which allows the intermingling of banking and commerce, would make it nearly impossible to monitor the effectiveness of these firewalls.[123]

Nevertheless, the U.S. banking system must be modernized in order to remain competitive within the financial system.[124] Until Congress can formulate a proposal that will protect taxpayers and ensure the integrity of the banking system, however, the United States is better served by its current system that maintains a barrier between banking and commerce.[125]

120 *See* Gerard Baker, *Japan's Banks Lose Protective Shield*, FIN. TIMES, Sept. 22, 1995, *available in* 1995 WL 4348319, at *3-4 (detailing haphazard lending as cause of jusen crisis).

121 *See Financial Services Restructuring: Hearing on H.R. 10 Before the Senate Comm. On Banking, Housing and Urban Affairs*, 105th Cong. (1998), *available in* 1998 WL 340054, at *3-4 (statement of Ralph Nader, Consumer Advocate) (noting that following savings and loan bank failures of 1980s, legislators made implicit promise to American public new risks would not be added to deposit insurance and federal safety net without strengthening of regulation, promise that H.R. 10 fails to keep).

122 *See id.* at *18 (stating that great concern with mixing banking and commerce is potential for banks to make credit decisions based on "incestuous corporate relationships" rather than credit worthiness; "[o]nce the foot is in the door, the pressure to ease the necessary arbitrary limits, lubricated by ever larger political contributions, will grow stronger. The fissures in the dike will erode, new compromises will be struck, and the risks and concentrations will inexorably mount.").

123 *Financial Modernization Restructuring, Before the House Committee on Banking and Financial Services*, 104th Cong. (1997), *available in* 1997 WL 268302, at *32 (testimony of Alan J. Fishbein, General Counsel, Charter for Community Change) (stating that combination of banking and commerce will result in tremendous increase in amount of regulation to be enforced).

124 *See* Sullivan, *supra* note 4, at 977 (arguing that financial services industry must be modernized); Lance, *supra* note 16, at 307 (noting that future of banking industry is imperiled by Glass-Steagall restraints); Plotkin, *supra* note 7, at 404 (stating that statutes are stifling banking industry and forestalling growth).

125 *See* More, *supra* note 3, at 436 (arguing against repeal of Glass-Steagall by citing necessity of preserving barrier between banking and commerce); Halpert, *supra* note 3, at 493 (stating that Glass-Steagall prohibitions are needed to ensure safety of entire financial system).

CONCLUSION

Congress passed the Glass-Steagall Act to protect against speculative lending by the banking industry. They believed that this practice undermined the safety and soundness of the Banking Industry. Over six decades later, this notion still holds true. While it is clear that the banking industry has been transformed since the depression era act was passed, the fundamental premise behind the act remains valid today. H.R. 10 includes provisions that should not be included in a financial modernization plan. While we believe that a new plan is needed, we also believe that recent history reveals that permitting banks to engage in unfettered non-financial activity is a mistake that could likely prove fatal to the very financial structure we seek to strengthen.

Noelle T. Heintz & Robert M. Travisano