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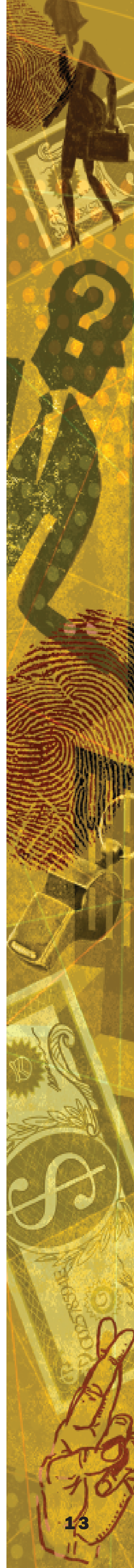

Did Repeal of Glass-Steagall for Citigroup Exacerbate the Crisis?

Freed from the restrictions of the Glass-Steagall Act, giant bank-holding companies appear to have been focused more on meeting the expectations of Wall Street analysts than on protecting depositors' funds from risk.

Amid the finger-pointing going on in regard to the current banking crisis, it seems that we may be forgetting who the real culprits are. Should we blame the bungling bureaucrats in Fannie Mae, Freddie Mac, the Federal Reserve, the Securities & Exchange Commission (SEC), and the Treasury Department? Or are the regulators (perhaps they should be called "watchers" considering their recent performance) not at fault for problems that arise? After all, regulators are only interpreting the will of Congress, which passed the laws the regulators are supposed to be enforcing.

Or should we put the blame for the crisis on the scheming actions of CEOs of banks like Citigroup (Citi) and their hirelings, who take advantage of every legal loophole, only look out for their own interests, and forget they are fiduciaries for other stakeholders, which include their depositors, shareowners, employees, and the general public? After all, the highly regulated commercial banking industry should be recognized as at least a quasi-public utility, existing in large part for the benefit of depositors who need to have continuing confidence that their funds are safe.

After the savings and loan disaster caused the previous banking debacle, the FDIC Improvement Act of 1991 mandated that insured institutions employ adequate controls to manage their risks in order to maintain the safety and soundness of banks and thrifts. Perhaps the financial services landscape has changed so much since then that bank-holding conglomerates such as Citi are so diverse that any focus on managing risks for bank depositor protection has become so diluted it hardly exists.

It will take a major overhaul of business culture and its governance to reduce the tremendous costs of unethical behavior.

Citigroup was formed in April 1998 through the merger of Citibank and Travelers Group. In addition to the traditional banking services, this $140 billion umbrella encompassed brokerage, investment banking, and several insurance companies, including Travelers.

More recently, urged on by former U.S. Treasury Secretary Robert Rubin, Citigroup's director and chair of its Executive Committee, Citi acquired heavy exposure to Collateralized Debt Obligations (CDOs) based on subprime mortgages. By 2006, Citi had become the second largest underwriter of CDOs. Unfortunately, Citi's risk management function failed to rein in these activities as danger signals began to appear. (In January 2009, Rubin resigned from Citigroup with some observers describing it as "in disgrace.")

Similar to what other firms did (see December 2007 column, "Who Should Be Blamed the Most for the Subprime Loan Scandal?"), Citi's risk efforts relied heavily on the flawed work of credit rating agencies. It believed that the possibility of trouble with its CDOs was so tiny (less than 1/100 of 1%) that it excluded them from its risk analyses—even after Bear Stearns ran into serious subprime trouble in the summer of 2007.

Unfortunately, the continuing subprime crisis hit Citi hard, resulting in the largest federal bailout in history. In October and November 2008, Citi received a total of $45 billion in equity funding from the Troubled Assets Relief Program (TARP). Treasury made additional guarantees to assume losses (with taxpayer money).

Because Citi became such a diverse financial services enterprise in 1998, it was legally incompatible with the Glass-Steagall Act of 1933 (G-S), the legislation that established the Federal Deposit Insurance Corporation (FDIC) and forbade banking entities from acting as both a commercial bank and an investment bank or broker. Reasons for the establishment of G-S include:

1. Conflicts of interest characterize the granting of credit lending and the use of credit investing by the same entity.
2. Depository institutions possess enormous financial power by virtue of their control of other people's money; their influence must be limited to ensure soundness and fair competition in the market for funds.
3. Securities activities can be risky and can threaten the integrity of deposits. Since the government insures deposits, it could be required to pay large sums if securities losses led to bank failures.
4. Managers of depository institutions may not be conditioned to operate prudently in more speculative securities businesses.

In spite of this compelling rationale, the Gramm-Leach-Bliley Act (GLB) was enacted in November 1999, repealing G-S. This legislation was encouraged by then-Treasury Secretary Rubin, who joined Citigroup shortly thereafter. GLB eliminated the ban on entities engaging in both insurance underwriting and commercial banking, thus retroactively approving the combination of Citibank and Travelers. GLB also required strict conformity to the Community Reinvestment Act (CRA), which requires depository institutions to meet the needs of borrowers, including low- and moderate-income neighborhoods, thus eliminating "red-lining."

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Many observers believe GLB allowed firms such as Citi to focus too much on meeting the expectations of Wall Street analysts and the high rewards inherent in investment banking and to avoid recognition of the risks necessary to achieve them. The giant bank-holding companies seemed to minimize the protection of depositors' funds from excessive risk that is so necessary in commercial banking. The concentration of wealth in fewer hands also fueled a level of competitive greed that seemingly overcame good business sense.

Long-time former Federal Reserve Chairman Alan Greenspan testified before Congress in October 2008 that he had made a "mistake" in believing that banks operating in their own self-interest (without regulatory oversight) would be sufficient. He said that he had found "a flaw in the model that I perceived is the critical functioning structure that defines how the world works." Greenspan bluntly called the current financial crisis a "once-in-a-century tsunami." Greenspan said that he and others who believed lending institutions would do a good job of protecting their shareowners are in a "state of shocked disbelief."

What Greenspan is really saying is that the CEOs and staffs of companies such as Citigroup can't be trusted to act in the interest of their own shareowners, let alone in the public interest, even when a regulator is supposed to be looking over their shoulder. The message we should take from the current financial crisis is that people will act in their own short-term self-interest unless there are strong cultural, not legal, impediments.

Unfortunately, it appears that

acting ethically in the long-term best interests of others isn't very popular these days. Over just a few days, the words "major fraud" jumped out of almost every page of the newspaper. Bernie Madoff apparently lied to his friends for years while making off with an estimated $50 billion with only a one-man storefront CPA firm watching him. Fry's Electronics Inc. executive Ausaf Umar Siddiqui was arrested on federal charges that he defrauded Fry's of $65 million in a kickback scheme. Lawyer Marc Dreier was accused of causing losses of at least $380 million by scamming hedge funds into buying worthless securities. In India, the CEO of Satyam Computer Services said he "created" a billion dollars of fictitious cash. "This is probably the biggest surge in financial crime [perhaps] since the savings and loan crisis of the 1980s," said David Cardona, head of the criminal division in the FBI's New York office, where most of the Bureau's Wall Street probes start. Yet fewer fraud cases are being prosecuted by the FBI and the Justice Department because of reductions in staffing.

The new administration has promised to correct past ills through stronger regulation of the financial services industry. The addition of more regulation without changing the basic structure of the industry isn't the answer. At least some Glass-Steagall requirements need to be reinstated. Erection of "Chinese Walls" (a virtual barrier between divisions to avoid conflicts of interest) that separate commercial banking from insurance and investment banking in the same corporate entity won't work. This approach only invites action to legally circumvent the objectives of separation. Totally separate legal entities are necessary to permit good governance functions, transparency, and necessary regulatory oversight to promote regained trust in a market-based savings and investment community. Transparency and accountability, two ethical characteristics very much needed today, can be better achieved in smaller, less complex, and less diverse entities.

It will take a major overhaul of business culture and its governance to reduce the tremendous costs of unethical behavior. As mentioned in last month's column, the Federal Sentencing Commission has it right by requiring organizations to have a strong ethical culture.

Congress has to be up to the task of prescribing strong medicine for curing the ethical ills of business. The new administration must make sure the medicine works. **SF**

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