CAPITAL MANAGEMENT GROUP, INC.

Alternative Investment Strategies

A Banking Holiday Does a Market Good

On March 5, 1933, a day after his inauguration, Franklin D. Roosevelt declared a bank holiday, forcing a four day closure of all banks and halting all financial transactions. The country was in the midst of the most frantic run on banks in its history and FDR wanted to stem the assault on deposits. Four days later, the Emergency Banking Act was passed to facilitate a review of all banks to determine which could reopen for business. Within 300 days of the Act's passage, over 5,000 banks reopened for business. While the EBA did help provide relief for banks and helped restore faith in banking institutions, a more permanent solution was not created until June of that year when Congress passed the Banking Act of 1933, more commonly known as the Glass-Steagall Act of 1933.

While the Great Depression was not the first financial panic in United States history, it was by and large the most severe the country had ever faced. During the Roaring Twenties, Americans purchased consumer goods on cheap credit and businesses relied on credit to increase production and expand their capital facilities by purchasing factories, warehouses, and heavy equipment. Banks continued to make loans but consumers were no longer spending and deflationary pressures began forcing companies to contract. Banks on Wall Street had not maintained proper capital reserves and were increasingly exposed to the stock market at the same time as the assets which were collateralizing their loans (namely real estate) were depreciating. Following the crash of 1929, one in every five U.S. banks failed as capital reserves were inadequate to meet depositors' withdrawals.

Although the Great Depression had numerous causes and economists developed several theories attempting to explain it, the American public and politicians pinned much of the blame on the speculative excesses of banks and the conflict of interest created by commercial banks underwriting stocks and bonds. The legislative reaction came in the form of the Glass-Steagall Act, which called for the separation of commercial and investment banking and also established the Federal Deposit Insurance Corp. (FDIC). In 1956, the Bank Holding Company Act extended restrictions on banks by prohibiting bank holding companies that own two or more banks from engaging in non-banking activity.

However, in the 1960s, banks began to lobby Congress to loosen the restrictions of Glass-Steagall allowing them to enter the municipal bond market. In the early 1970s, brokerage firms began encroaching on banking territory by offering money market accounts and the push for deregulation became stronger as banks cried foul. By the late seventies, economic stagnation convinced politicians that the regulatory environment was excessive and Jimmy Carter began deregulating the airline and trucking industries.

In early 1987, three major New York banks, Citicorp, J.P Morgan and Bankers Trust approached the Federal Reserve and made their case for tearing down the Chinese wall that Glass-Steagall had created. Thomas Theobald, then Vice Chairman of Citicorp, cited several reasons why Glass-Steagall was antiquated, including more knowledgeable investors, a very effective SEC and "sophisticated" ratings agencies. In the spring of 1987, after hearing the banks' proposal, the Federal Reserve Board voted 3-2 in favor of easing regulations under Glass-Steagall and allowing banks to handle several underwriting businesses, including commercial paper, municipal revenue bonds, and mortgage backed securities. Federal Reserve Chairman, Paul Volcker, was one of the dissenting votes. He was unconvinced by the arguments made by Theobald and expressed his fears that lenders would lower loan standards in pursuit of lucrative securities offerings while marketing bad loans to the public. In August of 1987, Alan Greenspan, formerly a director at JP Morgan and proponent of deregulation, replaced Paul Volcker as Chairman of the Federal Reserve.

Over the next ten years, Congress repelled several assaults on Glass-Steagall, all the time loosening the amount of underwriting activity permissible under Section 20 of the Act (initially set at 5% of each bank's revenue). By the end of 1996, with the support of Chairman Greenspan, the Federal Reserve allowed bank holding companies to own investment bank affiliates, with up to 25% of their business in securities underwriting. In 1997, Bankers Trust (now Deutsche Bank) bought investment bank Alex Brown & Co., becoming the first U.S. bank to acquire a securities firm. The acquisition started a streak of consolidation in banking and financial services that was topped later that year by the largest corporate merger in history (at the time) when Citicorp and Travelers merged, creating the largest financial services firm in the world. At this point, Glass-Steagall was in its death throes, but the merger was nonetheless grossly in violation of the remaining provisions. Strong lobbying on the part of Traveler's, Sandy Weil, and Citicorp's John Reed, received a positive response from Chairman Greenspan and eventually from Congress. After much deliberation the merger was allowed to go through but with restrictions and a timeline for Citigroup to divest itself of the insurance business.

In November 1999, the signing of the Financial Services Modernization Act (also referred to as the Gramm-Leach-Bliley Act) by President Clinton was merely a formality, as the Glass-Steagall Act was already obsolete. Over the next three years, the aftereffects of deregulation were evident as banks issued strong buy ratings for the same companies they were underwriting and questionable accounting practices led to the bankruptcies of Enron and WorldCom. To date, the NASDAQ Composite index is still over 50% off its 2000 high.

While asset bubbles have occurred throughout the history of the U.S. and have been diversified across different sectors, banks have tended to be at the heart of the problem. Irrational exuberance, as Mr. Greenspan eloquently put it, seems to manifest itself all too often in the form of too much money chasing the next great asset. Currently that asset is real estate, "the one asset that never goes down" as most speculators and mortgage underwriters would have you believe.

The current housing bubble has shown how banks have added fuel to the fire by packaging levered collateralized mortgages backed by inflated housing prices and dubious credit scores. Mr. Theobald's argument couldn't have been more contrary to reality as investors have become more reliant on ratings agencies than their own fundamental analysis, while the SEC lacks the resources to properly regulate a more complex derivative market.

To the bankers' credit, they are not the only ones to blame here. As it turns out, the ratings agencies have been anything but "sophisticated" and the conflict of interest with respect to their ratings on structured products (their biggest moneymaker) has institutional investors standing on the edge of a cliff as ratings downgrades on many of these products could create forced liquidations for large portfolios. The importance of the ratings agencies is headline news again as the two largest monoline bond insurers, Ambac and MBIA, could potentially be downgraded due to inadequate capital reserves. The market and banks in particular are concerned that the insurers will not be able to pay out claims.

Both Ambac and MBIA started out in the 1970s as insurers of municipal bonds, but more recently their growth has come from insuring structured products, such as MBS (mortgage backed securities) and CDO (collateralized debt obligations). Wall Street banks, such as Merrill Lynch, have relied on the monolines to insure many of the structured products they sold in recent years, while at the same time buying protection for the MBS and CDO still on their balance sheets. In December 2007, ACA, another insurer, was downgraded, prompting Merrill to write down $1.9 billion of exposure to the company. As the value of sub-prime mortgages continues to plummet, the credit ratings of bonds and structured products underwritten by the insurers will fall, further driving down their value and impairing their lending capacity. In addition, borrowing costs for states, cities and counties will also rise as the spread on municipal bonds would increase sharply with a weaker credit rating for the insurers.

The markets have been waiting with bated breath as Ambac has been working to raise the capital they need. To its disappointment, Ambac has decided to raise $1.5 billion through a common stock and convertible debt offering, not through a consortium of banks that had been proposing splitting the company into two: the municipal bond business and the structured product business.

To the average investor, the incestuous relationship between banks, insurers and ratings agencies could make their head spin. Although the creation of Glass-Steagall was an overreaction to banks' role in the Great Depression, its central tenet, the separation of the banking and financial services industries would have helped to silo some of the risks the market can't quite identify now. As it is, financial markets continue to wait for the next casualty of the sub-prime meltdown while banks scrutinize their various counterparties with greater skepticism.

The current credit crisis has shown central bankers and government regulators just how complex the global financial system has become. Years ago, who would have thought that defaults on mortgages by American homeowners would force European or Chinese banks to write-down billion dollar losses? In the short term, the government and the major Wall Street banks will continue to find band-aids for each new problem, but it is clear that a serious discussion is needed on banking regulation, specifically to address the opaque OTC derivative market. If large institutional investors, such as pensions, are to have any confidence in the products and ratings they are buying, Congress needs to work harder to find long term solutions rather than parading to their constituents in front of Chairman Bernanke. Incidentally, it was Citigroup, the behemoth that finished off Glass-Steagall, which was rumored to be leading the banking consortium bailout of Ambac. Coincidentally, Mr. Theobald now gets to see the effects of his tough lobbying of the Federal Reserve 20 years ago, from his comfortable seat as a director of Ambac. The markets could certainly use another banking holiday.