The Real Lesson of the Asian Meltdown

Too bad nobody's listening

BY MICHELLE COTTLE

TRUTH BE TOLD, MOST AMERICANS dislike their bank. Long lines, surly tellers, obscene ATM fees, and a wait of anywhere from three days to 30 years for a check to clear have combined to make banks a source of minor irritation for most consumers. The banking *system*, however, is another matter entirely. Unlike the stock and bond markets, with their risk and drama and potential for big returns, the banking industry is decidedly less glamorous. Stories in the press, usually buried on page 12 of the business section, positively ooze with steamy talk of prime rates, loan portfolios, and capital requirements. Hardly the stuff of which Hollywood blockbusters are made. As such, most of us never think about the business of banking at all. Until something goes wrong. At that point, all hell breaks loose and everybody wants some answers.

Such is the case with the recent meltdown in Asia. Prior to last summer, few Americans could have told you what continent Thailand is on, much less what the country's financial system looks like. But starting in early July, when the value of the Thai currency, the baht, fell through the floor — triggering financial shock waves that soon brought down the Philippines, Indonesia, Malaysia, and South Korea — U.S. newspapers from Boston to Phoenix were awash in articles detailing the economic downfall of the Asian tigers.

Rehashing the collapse of Japan's bubble economy in the early '90s, financial pundits traced the roots of the recent crisis to Southeast Asia's having emulated the Japanese model, with its "cozy" relationships between government, banking, and industry. Under Japan's *keiretsu* system, for instance, banks, trading companies, and industrial firms share common stock holdings, an arrangement that lends itself to preferential — and often unwise — financial dealings. Similarly, South Korea's economy is characterized by close ties between its banks and its *chaebol*, the handful of giant conglomerates that dominate the economy. Under such a system, in which banks have an understandably tough time maintaining their objectivity and independence, Korean banks lent too much money to their industrial partners during good economic times, only to be left holding the bag when many of their ventures failed. Thus when Kia Motors collapsed last July, for example, it took the Korea First Bank down with it.

Until recently, rapid growth, coupled with lax accounting and disclosure policies, helped hide the tigers' bad lending practices, overextended banks, and the general lack of oversight of the region's financial institutions. In the months leading up to the storm, everyone from *Money* magazine to the International Monetary Fund was touting Southeast Asia's investment potential and economic fundamentals. When the bubble burst, however, the banks (and the financial experts) were caught with their proverbial pants down. And as talk of bailouts by the IMF swirled around Washington and Wall Street, a major sticking point in the deals became whether Asian leaders would accept the requisite financial reforms, including greater transparency in the region's financial systems, tighter loan standards, a crackdown on insolvent banks, and improved accounting procedures. The U.S. media joined in the call for reform. A Jan. 4 article in *The Washington Post* criticized the lack of government oversight of Thailand's banks as part of a "deregulated financial system run amok." Suggested the *Post*, "As with the savings and loan scandal in the United States, which led to a shakeout of the American finance sector and greater regulation, so too Asia might retool by cleaning up its banking mess."

One by one, with varying degrees of resistance, the ailing nations accepted the IMF's conditions, and soon the U.S. media were celebrating the coming westernization of East Asia's economies. Even China, which escaped the storm this time around, announced plans to restructure its banks more along the lines of the U.S. Federal Reserve system in an effort to "learn the lessons from Southeast Asia and adopt a more cautious approach," explained the governor of the People's Bank of China. U.S. financial pundits, although acknowledging the gravity of the situation, seemed positively gleeful that "the Asian miracle" had at last collapsed, offering definitive proof that Western capitalism is king. "This Year's Economic Lesson: Japan's Model Failed," proclaimed a headline in the Dec. 30 *Wall Street Journal.* "Asia Miracle Fades: Sun sets on crony capitalism," crowed the Nov. 26 *USA Today.*

With fallout from Asia rattling markets from Moscow to Sao Paolo, the international financial community launched discussions on how to prevent future meltdowns. Talk of a global regulatory system was bandied about by heavy hitters ranging from Treasury Secretary Robert Rubin to billionaire currency speculator George Soros, with Soros going so far as to assert that "the private sector is ill-suited to allocate international credit" and proposing an international oversight agency to help stabilize the world's banking system. (You know the situation is serious when the Übercapitalists start sounding like World Federalists.)

So, with all this excitement on the international financial scene, what have U.S. policy makers learned from the upheaval? Damn little, it appears. As a matter of fact, right up until Congress' winter recess — even as South Korea & Co. were being told to westernize their financial systems ASAP — members of the House were working fast and furiously to pass a bill that would move the U.S. banking system closer to that of South Korea or Japan. That's right, closer.

In late October, the House Commerce Committee put its stamp of approval on H.R. 10, aka the Financial Services Competition Act of 1997. It seems that, in order to keep up with foreign banks, as well as with rival domestic institutions such as stock brokerages, U.S. banks want to expand their "profit centers" beyond the traditional check cashing/money lending business. Enter H.R. 10, a comprehensive deregulation bill that would not only tear down the legal walls now separating the banking, securities, and insurance branches of our financial sector, but would also undercut laws barring banks from owning, or being owed by, non-finance-related businesses (e.g., currently, Bill Gates and Microsoft cannot own NationsBank). Largely because of squabbling between the banking and insurance industries — both of which have a considerable stake in the fine print of a deregulation bill — the Commerce Committee failed to reconcile its version of H.R. 10 with the one approved earlier by the Banking Committee in time for a floor vote. Undaunted, Banking Committee Chairman James Leach has pledged that "financial modernization" — that's code for banking deregulation — "will be among the first major issues taken up by the House next year."

Now, East Asia aside, those who recall the S&L debacle of the '80s can probably think of one or two reasons why efforts to deregulate the U.S. financial sector should be approached with caution. After the Garn-St. Germain Act of 1982 cleared the way for the thrift industry to expand its services beyond the basic home-loan business, it took all of seven years for such well-intentioned folks as Charlie Keating to make the industry so "modern" and "competitive" it required a $130 billion (and counting) bailout from taxpayers.

Washington, however, is not known for its long-term memory, which is precisely why Asia's current woes should be of intense interest to U.S. policy makers. Because whatever combination of factors ultimately led to Asia's implosion, its freewheeling banking style did not do good things for the region. When asked about such concerns, however, Undersecretary of the Treasury John Hawke — a veteran advocate of banking deregulation — dismisses the comparisons. "The U.S. has a totally different kind of system," he insists. "I don't think you can look at whatever happened over [in Asia] and say this proves the case for the U.S., where we have an entirely different set of regulatory laws and traditions." Perhaps. But taking a step toward the South Korean or Japanese system seems a peculiar way to maintain these different traditions. Besides, a system-wide meltdown is merely the worst-case outcome of the "modernization" plan wending its way through Congress. There are plenty of more immediate, less dramatic ways the American people (and economy) could suffer, some of which can already be seen across Europe in countries that have "modernized" their banks. So before Congress resumes its crusade to make our financial system more competitive, the public would do well to take a close look at the debate. Otherwise, the next economic crisis to hit the front page of *The Wall Street Journal* may have its roots in New York rather than Bangkok.

Divided We Stand

First, a bit of groundwork. The U.S. financial system can, for the most part, be divided into three major categories: insurance, securities, and banking (which typically includes the savings-and-loan industry). But commercial banks hold a unique place in our economy. Customer deposits are guaranteed by a government insurance fund to preserve consumer confidence in — and reduce the danger of a run on — the banks during an economic downturn. In exchange for access to this safety net, banks' activities are circumscribed by law to minimize financial risk to the taxpayer. Under the Glass-Steagall Act of 1933, passed in the wake of the 1929 stock market crash, banks are not allowed to engage in the securities business and vice-versa. Nor, according to both federal and state laws, may banks enter the insurance industry. The aim of this compartmentalization is to protect the "safety and soundness" of our economy by limiting undue consolidation of resources and preventing conflicts of interests between banks and non-banking affiliates. In other words, we don't want a handful of powerful financial conglomerates holding the rest of the economy hostage, nor do we want banks taking stupid risks with federally insured funds for the benefit of their business affiliates.

Now, fans of deregulation tend to be more optimistic than the average shmoe. With an unshakable faith in the better angels of human nature, they maintain that such laws are unnecessary and that, if only government would keep its meddlesome mitts off the nation's financial institutions (or telecommunications firms or public utilities or ...), the upstanding, ultrarational professionals who run these industries could usher in a new era of perfect competition, efficiency, and productivity. Opponents of Glass-Steagall point to studies indicating that, contrary to prior belief, the 1929 crash had little to do with banks' involvement in the securities business, and they insist that the law serves only to undermine U.S. banks' competitiveness in the global marketplace. Moreover, despite bankers' innate desire to do what is right, deregulators argue, limiting banks' activities actually *forces* them to take greater risks in order to turn a profit on the services they may provide. (This, they claim, was the true cause of all those big bank failures in the late '80s and early '90s.) If laws such as Glass-Steagall were repealed, so the logic goes, commercial banks could move smoothly — and cautiously — down the path toward providing customers with one-shop-stopping for their financial services needs. (Lost in this happy world of pure market capitalism, deregulators seem oblivious to the irony that, as the *Associated Press* recently noted, Japan is hoping to make its financial sector more competitive with a "Big Bang" reform package aimed at "scrapping regulations ... that have fostered cozy ties between *banks, brokers, and insurance companies*." [italics added])

Even as South Korea & Co. were being told to westernize their financial systems, the House was working to move the U.S. banking system closer to that of South Korea and Japan.

Whatever the origins of our compartmentalized system, the potential dangers of dismantling it remain. First, there is the risk to individual consumers. If NationsBank and Travelers insurance merge, for example, how can we prevent a system under which the resulting conglomerate, or some of its more enterprising employees, can subtly suggest that a loan is more likely to be approved if the applicant also buys her homeowners insurance from the firm?

Then there are the more systemic concerns. Let's say Chase Manhattan decides to buy Merrill Lynch. If Merrill Lynch later loses a bundle on pork bellies, how long before Chase feels compelled to bail out its subsidiary, using insured deposits? Not only does this expose the bank's shareholders and depositors to serious losses, it gives Merrill Lynch less incentive to follow cautious investment policy. After all, why not take risks in the market if you have a guaranteed source of government funds available to save your bacon when you screw up? (Which, incidentally, is Congress' major objection to bailing out Asian banks and their foreign creditors.)

Advocates of financial consolidation argue that safeguards already exist to prevent such conflicts of interest. But as Ricki Helfer, then-chairwoman of the Federal Deposit Insurance Corp., told a congressional subcommittee last March, "In times of stress, firewalls tend to weaken. ... We found during the banking crisis [of the late '80s] that the firewalls tended to get 'squishy' when significant problems were raised in the banking organization." Just how squishy is "squishy"? When the stock market crashed in 1987, then-megabank Continental Illinois (which had already undergone a $4.5 billion government bailout in '84) breached internal firewalls to prop up a securities subsidiary it operated by special permission from regulators. Ignoring restrictions on the amount banks may loan to subsidiaries, Continental extended $240 million to securities dealer First Options, to cover $90 million in trading losses. Regulators reprimanded Continental, but bank executives dismissed the criticism. Whether or not Continental had done anything wrong was simply "a matter of interpretation," the bank's chairman and CEO, Thomas Theobald, told the *Chicago Tribune* shortly after the bailout. "The bank took the view, he said, that a loan to one of its subsidiaries wasn't subject to the lending limit." So much for those fabulous firewalls.

What's more, as mega-mergers yield conglomerates too economically important for the government to allow to fold, regulators will become increasingly less inclined to interfere in such shenanigans and this type of big-ticket rescue will likely become increasingly common. Already, this "too big to fail" phenomenon characterizes the U.S. banking sector. Over the past decade, regulators have opted to prop up a variety of major banks, at some pretty impressive costs: $4 billion for the 1988 bailout of First Republic, $2 billion for the 1990 MCorp. bailout, $2.3 billion for the Bank of New England in 1991 .... And just think of the exciting bailout possibilities there will be once a few dozen mammoth banking-insurance-securities conglomerates rule our economy.

Mend It, Don't End It

When all else fails, the fallback argument for financial consolidation is a time-honored classic used to advocate tossing out everything from gun laws to taxes: The current rules don't work anyway. As is so often the case, this statement has some truth to it — but entirely misses the point. The development of new financial products and services has indeed blurred the distinction between banks and other financial institutions. For instance, money market accounts offered by securities firms can function much like checking accounts. What's more, despite Congress' inability to deregulate the industry, administrative and judicial rulings in recent years have allowed banks to circumvent existing limits on their activities. The two chief banking regulators — the Federal Reserve and the Office of the Comptroller of the Currency (OCC) — have used a variety of legal loopholes to let banks and bank holding companies into areas such as bond underwriting. (This helps explain how Citicorp racked up $188 million in pretax trading losses in late 1997, thanks largely to the Asian upheaval.) Most recently, a November 1996 decision by the OCC cleared the way for its banks to run subsidiaries engaged in securities underwriting and other services closed to banks themselves. Not to be outdone, one month later the Fed ruled that bank holding companies may control firms that earn as much as 25 percent of their revenues from the securities business. The result was a flurry of prominent banking-brokerage marriages, including NationsBank's $1.2 billion purchase of Montgomery Securities and Bankers Trust's $1.7 billion buyout of Alex Brown. Also in '96, a Supreme Court ruling dismantled many of the barriers keeping banks out of the insurance field. "Since then," reported *The American Banker* this January, "negotiations for mergers and joint ventures between banks and insurers have skyrocketed.... [A] consultant at [Risk Management Services] said he expects half of all banks to be selling insurance by year-end."

But just because banks have had their powers expanded an inch does not mean we need to give them a mile. If anything, the fact that the old laws are widely considered inadequate to deal with the changing financial landscape suggests that what we need are better regulations, not weaker ones. Otherwise, we may soon find ourselves choking on the words of Joseph Stiglitz, senior vice president and chief economist of the World Bank, in his Oct. 31 piece in *The New York Times*: "Inadequate oversight, not over-regulation, caused these problems. Consequently, our emphasis should not be on deregulation, but on finding the right regulatory regime to re-establish stability and confidence." Stiglitz was, of course, referring to the banking crisis in Asia, but if the shoe fits ...

Sadly, deregulators' optimism knows no bounds, and financial consolidation is only Step 1 on the agenda. Congress also aims to do away with prohibitions on banks' owning, or being owned by, nonfinancial commercial firms. Under such an open system, Bill Gates could buy himself a couple of federally insured banks and go into the lending business. Of course, as banks establish ties to unrelated and unfamiliar industries, the risk to the economy is compounded and the possibility for conflicts of interest explodes. If Microsoft owns a bank, for example, and a competing software developer applies for a business loan, who can say for certain that the parent company's interests won't color the bank's lending judgment? In such a case, would we really want to bank on Bill "thumb your nose at the federal anti-trust suit" Gates' respect for healthy competition?

Here again, Congress doesn't need hypothetical models to foresee potential problems. In addition to the crisis in Asia, the mixture of banking and commerce has caused trouble in France (Credit Lyonnais), Spain (Banesto), and Germany (Deutsche Bank). In February 1997, the Congressional Research Service reported: "Once viewed as a growth mechanism, German universal banking seems to be troubled by characteristics of private-insider transaction." Similarly, Brookings Institution banking expert Martin Mayer noted in a March '97 *Wall Street Journal* piece on banking deregulation in France, Spain, Sweden, and Finland that "... in every one of these countries that opted for a more 'universal bank,' the outcome was the same: failed big banks, money-losing nonfinancial subsidiaries, huge bills to the taxpayer ... and direct government intervention in the businesses these banks had bought and mismanaged."

But what about keeping banks competitive through new "profit centers"? In a May 1997 statement to the House Banking Committee, the General Accounting Office's chief economist, James Bothwell, reported: "GAO found that the potential benefits of mixing banking and commerce generally lacked empirical support or could be realized without removing the current restrictions. GAO's work also indicated that eliminating the current separation could pose a variety of risks to the safety and soundness of the financial system, the deposit insurance funds, and to consumers and taxpayers." Hardly a glowing recommendation.

House Banking Committee Chairman James Leach is somewhat more emphatic: "Mixing commerce and banking simply doesn't fit our kind of democracy," Leach told fellow committee members last March. In a more recent statement he challenged: "[I]t should be clear there is no public support, no compelling public policy rationale, and no political necessity for such a breach. Indeed, the Congress would risk public scorn if it were to endorse a policy which would lead to conglomeration of ownership of assets in America, as well as an expansion of the deposit insurance safety net to commercial activities."

Unfortunately for Chairman Leach, who introduced H.R. 10 as a pure financial consolidation bill, both versions under consideration were amended to allow for the commingling of banking and commerce. At present, the bill would limit the percentage of a banking company's income that could come from nonfinancial activities. But such limits have a way of expanding over time. What's more, any legislation approved by the House would then pass through the kingdom of Senate Banking Chairman and deregulation cowboy Alfonse D'Amato, whose own "modernization" bill aims to do away with all restrictions on mixing banking and commerce.

The Trouble With Inaction

There is some good news in all of this: It probably ain't gonna happen — at least not this year. Despite all of the cheerleading over H.R. 10, Congress has tried to pass similar legislation at least a half dozen times in the last 10 years — and failed in as many tries. It seems that, as is the case with so many legislative matters, the devil is in the details: Although most of the major players agree on the broad outlines of a bill, conflict among the bankers, brokers, insurers, and even regulators over the particulars (and Congress' unwillingness to alienate any of these influential groups) promises to drag out the process a while longer. And no matter how close to success the "modernization" effort came in 1997, 1998 is an election year, and members of Congress — including Senator D'Amato, who's up for re-election in November — are loath to risk losing the financial largesse of either the American Bankers Association or the American Insurance Association. Already, D'Amato has tried to distance himself from the issue, announcing that he won't waste any more time hawking comprehensive reform until the House manages to pass a bill.

Now back to the bad news: Something really should be done to address the ongoing evolution of our financial sector. In recent years, reviews by the GAO found that the current financial regulatory system isn't really equipped to deal with existing institutions, much less "modernized" ones. Moreover, the piecemeal approach to deregulation being taken by the Fed and the OCC only makes things worse, resulting in "overlaps, anomalies, and even some gaps" in oversight, according to James Bothwell's May '97 testimony.

In fact, GAO data indicate that it's the regulators we should be pushing to consolidate, rather than the financial sector. At present, each branch of the financial tree has its own complex set of oversight requirements, resulting in a system that is fragmented, inefficient, and flat-out confusing. Banks can choose to operate under either a national charter (regulated by the OCC) or a state charter (issued by state banking commissions and overseen by either the Federal Deposit Insurance Corp. or the Federal Reserve). The Fed also regulates bank holding companies, umbrella corporations that operate banks, while the Office of Thrift Supervision oversees the S&Ls. Regulation of the insurance industry, on the other hand, is left up to the individual states. As for the securities business, although guidelines for fair trading practices are set and monitored by the Securities and Exchange Commission, the health of individual firms is not regulated.

Everyone clear on that? Don't feel bad. Neither, it seems, are the regulators. Under the present system, some activities and firms get double or triple oversight, while others slip through the cracks. In a March 1994 statement to the House Banking Committee, the GAO's then-comptroller general, Charles Bowsher, reported that banks were receiving contradictory advice from regulators concerning lending practices and that "[a]lthough the regulators try to coordinate their supervision and examination functions, this effort is not always successful and questions of accountability arise." Take the case of the failed Bank of New England: The OCC was responsible for the lead bank, while the Fed was responsible for the bank's holding company and the major expansion program it undertook in the late '80s. Each focusing on its own regulatory realm, neither the OCC nor the Fed took action to control the combination of risky loans and too-rapid growth that ultimately overwhelmed the bank. Which regulator should have stepped in to prevent the crash? As Comptroller of the Currency Eugene Ludwig told Congress in 1994, "it is never entirely clear which agency is responsible for problems created by a faulty or overly burdensome or late regulation."

Among other advantages, giving each arm of the financial sector one chief overseer might put an end to the ongoing turf wars, especially those among the banking regulators. Currently, the desire to keep banks happy and prevent "charter swapping" can lead to what has been elegantly termed "a competition in laxity," whereby one agency extends certain freedoms to the institutions it oversees, prompting other agencies to counter with similar, or even more liberal, allowances. When the OCC gave the go-ahead in '96 for national banks to start selling insurance, for example, Florida's banking commission promptly gave state-chartered banks the OK as well. And don't think it coincidence that the Fed's December '96 decision to loosen the reins on bank holding companies came so close on the heels of the OCC's November ruling.

Alternatively, an umbrella agency could be formed to monitor the system as a whole, as was proposed early in Clinton's first term. As James Bothwell told the House Banking Committee: "Our work on past financial institution failures has shown the importance of having an umbrella supervisory authority to assess how risks to insured institutions may be affected by risks in the other components of a holding company structure." Not surprisingly, this proposal is embraced by neither the regulators, who don't want to risk their current powers, nor the banks, who stand to benefit from their overseers' war of concessions. As a result, the Clinton administration dropped the issue early on, explains Treasury Undersecretary John Hawke, out of concern that further debate would only impede "the cause of modernization."

But it may be that the modernization "cause" *should* be impeded. No one seems particularly interested in improving the existing regulatory system, so much as loosening it up in the name of competitiveness. Certainly we want U.S. banks to remain strong both abroad and at home, but there is no impending crisis to justify deregulation before a solid, updated oversight system can also be put into place. (In fact, 1996 marked the banking industry's fifth consecutive year of record earnings.) And the people busy pooh-poohing the potential risks of "modernization" should consider the recent comments of former GAO chief Charles Bowsher to *The New York Times*: "In the early 1980s the U.S. confused deregulation with supervision, and the same thing happened in Asia."

Just something to chew on the next time you're waiting in line at the ATM.

The Man Behind Prop 209

Ward Connerly's latest crusade challenges the easy assumptions about him

By Louis Freedberg

Ever since Ward Connerly emerged as a leader in the fight to end affirmative action, he has had to fend off a stream of insults that might have sunk someone with a thinner skin.

Uncle Tom. House slave. Puppet of the white man. Traitor to his race. Minority counterrevolutionary. These are just some of the labels Connerly's many critics in California and around the nation have hurled in his direction. But none prepared the Sacramento businessman and regent of the University of California for the vitriol unleashed by his support last November for the university's proposal to extend health benefits to partners of its gay employees. The reaction, he says, has been even more extreme than the one prompted by his crusade against affirmative action, or as Connerly prefers to call it, racial preferences. "On race, at least you can sit down and talk with people," says Connerly, who led the successful campaign in support of Proposition 209, the initiative banning affirmative action programs in California. "Blacks will get in your face and get angry with you, but the level of debate doesn't begin to compare with this one. People start talking about morals, the Bible, degenerates, and before you know it, you're off in a terrible debate in which you just can't reason with people."

Until the university's vote last fall, Connerly had been routinely vilified by supporters of affirmative action (mostly left-of-center Democrats) — and virtually canonized by affirmative action critics (mostly right-of-center Republicans). But his support for domestic-partner benefits has begun to erode the one-dimensional views each side may have held of him.

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The Gathering Storm

It is only in the last few years of this decade that domestic-partner benefits have become a ubiquitous part of the American workplace. In 1982 the *Village Voice* became the first employer to offer these benefits to its gay employees; by 1990 fewer than a half dozen more employers had joined the alternative news weekly. Today, however, such benefits are offered by hundreds of universities (including Harvard, Yale, and Stanford), local governments (New York, Chicago, Los Angeles), and private employers (Microsoft, Shell Oil, Wells Fargo Bank).

The University of California, however, had lagged far behind not only other leading employers in the state, but most comparable universities as well. Richard Atkinson, the university's president, told the board of regents that the lack of domestic partner benefits had "affected its ability to recruit and retain the most qualified faculty, staff, and graduate students."

In the months leading up to the regents' tumultuous meeting, Connerly emerged as an unlikely champion of the benefits package. It passed by a razor-thin 13-12 margin. Gay rights advocates were ecstatic because of its symbolic importance: The University of California, with nine campuses, 166,000 students, and 127,000 employees, is the nation's largest institution of higher education. Few believe that the policy could have passed without Connerly's support.