Economic Growth Program

A Proposal for Genuine Financial Reform

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Is the president finally getting serious about real financial reform? Last Thursday, Obama called for the biggest regulatory crackdown on banks since the 1930s, proposing strict limits on the size of financial institutions and a ban on risky activities such as proprietary trading and internal hedge funds. If enacted by Congress, Mr. Obama's proposals could force Wall Street names like JPMorgan Chase and Goldman Sachs to spin off their huge hedge fund and private equity operations and stop making trading bets with their own money. New, unspecified limits on liabilities would go beyond an existing rule restricting banks to holding no more than 10 percent of U.S. deposits and prevent an investment banking-focused institution from growing so large as to pose a systemic risk.

These proposals represent a vast improvement over what has been hitherto proposed, but they do not go far enough. At this stage, the primary focus seems to be on banks. But it is worth recalling that an unregulated insurance company, AIG, was at the epicenter of the securitized mess that represents our current financial system. This fact alone suggests that a more broadly based approach, which incorporates all financial services intermediaries, might ultimately be required.

A straightforward restoration of something like the New Deal era Glass-Steagall Act's complete separation of investment and commercial banking activities would neither eliminate the problem of Wall Street firms that are "too big to fail" nor address the underlying practices which created systemic risk in the first place, largely because securitization has blurred the distinction between commercial and investment banking. Additionally, a revived Glass Steagall Act just gets us back to 1999, when banks were becoming irrelevant, with only 20% of total assets. The demise of Bear Stearns and Lehman Brothers shows that unsustainable bank-funded asset price booms can and do occur among smaller banks and even non-bank financial entities such as GMAC. In that regard, lower capital requirements coupled with greater restrictions on securitization, as opposed to higher capital requirements and fewer restrictions on securitization, is a better focus for the proposed legislation.

Ultimately, it is necessary to recognize that the liability side of the balance sheet is not the correct area to enforce proper regulation of the banking sector. The primary focus of bank reform should be on regulating the asset side of the balance sheet. This is particularly important, inasmuch as the FDIC has effectively guaranteed the main liabilities—the deposits. With that in mind, many activities of the banks need to be banned, taxed and/or substantially re-regulated.

To begin with, the $250,000 deposit ceiling should be removed altogether. The quid pro quo for the provision of this service by the FDIC would be restrictions on the activities of banks, so as to minimize systemic risk. With banks funded without limit by government-insured deposits and loans from the central bank, discipline should remain entirely on the asset side. Such discipline necessarily includes limiting banks to assets deemed 'legal' by the regulators and restrictions on off-balance sheet activities.

Simply enforcing higher capital ratios is insufficient, because these functionally act like a tax. Higher capital ratios restrict the banks' ability to lend, and thereby raise the returns demanded from the borrower. All they do is raise the common cost of funds for banks, which effectively is passed on to the consumer, contradicting current Federal Reserve policy to lower rates. Furthermore, higher capital ratios can also be easily gamed via accounting scams, which are usually ratified after the fact by our regulatory bodies (Basel II is a perfect illustration of this phenomenon).

Banks are set up and supported by government for the benefit of the economy in order to provide a payments system and lending in a way that is specifically defined by regulators. Consequently, banks should be prohibited from engaging in any secondary market activity because it serves no public purpose and may result in severe social costs in the case of regulatory and supervisory lapses. Banks should only be allowed to lend directly to borrowers and then service and keep those loans on their own balance sheets.

The other key component to ensure real financial reform is to establish markets that are liquid and deep. This means relying on a large number of smaller institutions carrying on traditional banking activities, rather than having these activities concentrated in the hands of limited number of highly capitalized global institutions. The former creates vibrant competition and a more stable banking system with less systemic risk, while the latter is anti-competitive and even more prone to systemic risk, given the large concentration of deposits in the hands of a minimal number of banks today, along with their insistence to perpetuate highly destabilizing activities contrary to public purpose.

In regard to proprietary trading, hedge funds, private equity operations, and other pools of unregulated funds should be allowed to continue to operate. But they should be allowed to fail when their bets go bad. What the vast majority of Americans need is a protected and closely regulated portion of the financial sector for those who do not want to take excessive risks, as Professor L. Randall Wray has proposed. And any institution that bets with "house money"—that is, that has access to the Fed in the case of a liquidity problem and to the Treasury in the case of insolvency—must be constrained. That is the direction that true reform ought to take.

The top four banks (BofA, Citi, JPMorgan-Chase, and Wells Fargo) hold about half of the country's deposit base. Failing to restrict their range of activities not only encourages each to "bet the bank" through excessively risky trades; it also tells all other financial institutions that their only hope is to join the "too big to fail" club through unsustainable growth that requires they adopt the same failing strategies adopted by the behemoths.

By the same token, if a bank instead relies on credit default insurance, then it is transferring that pricing of risk to a third party, which is counter to the public purpose of the current public/private banking system. Consequently, banks should not be allowed to buy (or sell) credit default insurance. The public purpose of banking as a public/private partnership is to allow the private sector to price risk, rather than have the public sector pricing risk through publicly owned banks. If the public sector wants to venture out of banking for some presumed public purpose it can be done through other outlets.

"Hold to maturity" is a good starting point for the deposit-taking institutions. To be sure, an inevitable byproduct of restricting securitization or proprietary trading is that it can and will reduce a bank's profitability. But such regulation

keeps them aligned with public purpose—namely, providing an ongoing, stable basis for lending, independent of market conditions—while avoiding the incentive for banks to game the higher capital requirements via questionable accounting scams.

Is it realistic to ban securitization outright? Recognizing that securitization is so firmly embedded in our capital markets structure, there may well be practical limitations to a "hold to maturity" standard for all financial institutions. But something must be done to mitigate the risks associated with securitization.

In its earlier incarnation securitization undoubtedly facilitated the expansion of lending to smaller businesses. However, the more recent proliferation of Frankenstein-style products, such as "collateralized debt obligations" or "collateralized loan obligations," has increased risk enormously, and misallocated it, without providing long-run advantages.

When a commercial bank makes a loan, the loan officer wonders, "How will I get repaid?" Because the loan is illiquid and will be held to maturity, it is the ability to repay that matters—and it is most prudent to rely on income flows rather than potential seizure and forced sale of the asset at some time in the possibly distant future and in unknown market conditions. On the other hand, when an investment bank makes a securitized loan, the loan officer wonders, "How will I sell this asset?"

In the words of Professors Wray and Eric Tymoigne:

The future matters only to the degree that it enters the value of the asset today because it will be sold immediately. Even the buyer of the asset need not worry about the distant future because the liquid asset can be unloaded quickly. Especially when confidence is high and euphoria reigns, it is easy to sell assets whose value is disproportionately determined by expected asset appreciation (and goodwill). The sky is the only limit to how much an asset's value might rise, hence no euphoric expectation can be easily dismissed. And any debt ratio can be justified as sound because it will automatically fall as the asset appreciates.

This is the downside to securitization.

To mitigate this impact, there is no reason why Congress could not rescind SEC rule 3a-7. This rule exempted securitized structures—the main elements of the so-called shadow banking system—from registration and regulation under the Investment Companies Act. This rescission would functionally act like a Tobin tax, insofar as the resultantly higher regulatory thresholds would significantly slowdown the proliferation of securitized financial products. In addition, by imposing a fiduciary responsibility on the issuer, Congress would ensure that the issuer retains "skin in the game" and thereby encourages more responsible lending behavior.

Taxing activities contrary to public purpose is another possible approach. In recent speeches, President Obama has discussed taxing certain banking activities, although the size of the tax he has proposed is too small. Moreover, the rationale for the tax is **not**, as the President recently suggested, "to get our money back". Rather it should be imposed to prevent a recurrence of the problem. The profits of the banks are running at around $90 billion a year. They probably pay out close to half this much in bonuses. A $120 billion tax over 10 years represents a mere 6 percent of the banks' profit/bonus mix. This is perhaps not trivial, but their after tax earnings would still represent a much larger share percentage of total profits to GDP than they did 10 years ago, even with the proposed new tax.

Ultimately, the test should be the following: Is the tax set at a sufficiently high threshold to render the activity in question uneconomic or, at the very least, does it substantially slow down its growth? Revenue raising per se is a secondary consideration. True, the kind of tax we are proposing would be punitive, but in the same manner in which a cigarette tax is punitive. When we tax cigarettes, we do it to discourage fundamentally unhealthy behavior, not because we want to raise tax revenue.

The current tax levels hitherto outlined by the president are insufficient to achieve this purpose. Here is what should be done:

- The tax rate should increase with asset size, rather than being a flat rate. Exempt small regional banks with under $25 billion in deposits. Make the tax progressive so it becomes increasingly larger as deposits become greater. $25-$50 billion in deposits is one fee (let's say 0.1%, that's $25 million on $25 billion in assets). Have it scaled to the point at which it becomes punitive. Collecting 1% annually on a trillion dollars in deposits will likely prove sufficient to deter activities contrary to public purpose.

- Phase in the taxes slowly over a few years, as Congressman Barney Frank has suggested, to give existing firms time to arrange efficient de-conglomerations. Importantly, legislators should characterize the target market structure, and empower regulators to define and alter tax schedules as necessary to achieve that target, rather than specifying them in law, to counter gaming by nimble financiers.

These necessary reforms of the U.S. banking sector need not be delayed by the actions or non-actions of America's international partners. Although U.S. authorities often like to pretend that their hands are tied by other regulators, in fact the U.S. holds a trump card in this situation: It can ban the banks of any country that does not regulate its banks seriously from doing business here. There are thousands of smaller American banks that will be happy to fill the void, and likely do the job far better.

The major consequence of thirty years of financial deregulation is that it has rewarded destructive competition rather than constructive competition. Indeed, it rewards those who maintained and grew their market shares by any means without any consideration for others (especially the financial well-being of borrowers), and it punishes financiers who refused to resort to unprofessional underwriting practices even if it meant a drastic reduction of their market share. The time has come to construct regulation which rewards the latter (usually small financial institutions) and punishes the former.

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