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Congress Should Force Big Banks to Stop Gambling with Our Money
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The furor over the inclusion of Senate Agriculture Chairwoman Blanche Lincoln's amendment in the Senate bill is becoming somewhat ludicrous. Good, knowledgeable people such as FDIC Chairman Sheila Bair and former Federal Reserve Chairman Paul Volcker have stepped up -- no doubt at the Fed's and Treasury's bidding -- to strew misinformation about one of the most important and powerful reforms currently under consideration in Congress.

The controversy stems from Lincoln's plan to ban banks from dealing derivatives—the complex "financial weapons of mass destruction" that brought down AIG. Like the Volcker Rule itself, the intent behind Lincoln's amendment is to remove risky activities from the economically essential banking functions that keep our society moving. By insulating these core banking operations from the risks inherent in derivatives dealing, Lincoln would ensure that problems in that market do not trigger the need for a future bailout, as they did so stunningly in 2008.

This is a sensible and reasonable response to an epic market failure. But let's look at the objections. Chairman Bair's concern was that forcing derivatives dealers out of banks would move the business into less regulated and more leveraged entities like hedge funds. While saying that banks should not engage in speculative activities, she argued that banks have an important role in creating markets for their customers while needing to hedge interest rate risks related to their core lending business. Chairman Volcker, too, took the position that providing derivatives is a normal part of a banking relationship with a customer and should not be prohibited.

These are assertions that need to be questioned. First, the assumption that taking derivatives desks out of banks will make the business less regulated and more leveraged is simply wrong. Lincoln's bill would require any derivatives dealer to meet strict capital standards, and follow transparency, anti-fraud and anti-manipulation standards, whether they're in a bank or not. But the equally important point is that the derivatives business couldn't possibly be less regulated and less well capitalized than the bank dealers are right now.

Second, if banks' role in selling derivatives is so important, and if it is part of the usual course of a banking relationship, why is it that only five banks -- J.P. Morgan Chase,
Citibank, Bank of America, Goldman Sachs and Morgan Stanley -- account for 90 percent of the market? Surely that kind of oligopolistic domination makes clear that it is not an activity normally undertaken by banks. Moreover, the sheer level of concentration among derivatives dealers is, in itself, systemically risky in addition to being anti-competitive.

Third, separating derivatives dealing operations from the business of banking does not mean that banks will be unable to hedge their banking risks. They can still buy derivatives just like airlines and farmers can—they just can't sell them, and use those sales to speculate with taxpayer-provided perks. Banks would not even be able to complain of lost profits—they don't actually have to sell the derivatives dealing process to another company, they simply have to establish a separate subsidiary under their own holding company. To reduce risks, that subsidiary must be independently capitalized and operate without access to the FDIC-guaranteed deposits or the Federal Reserve’s lending facilities.

For banks, the only significant loss will be the inability to sell and trade derivatives without disclosing the prices they charge, since most of their derivatives business will be conducted through clearing houses and exchanges. Right now, banks put all of this activity off-balance-sheet in order to hide pricing and evade regulations. Lincoln's bill would bring this business into the light.

Chairwoman Lincoln's provisions have the enormous value of getting the vast dealing and trading operations in derivatives out of the shadowy off-balance sheet world where they are now posted by the large bank and investment bank dealers. This will have very substantial systemic benefits for the derivatives market and for the banking system as well. Moving the selling and trading of these instruments into separate entities will increase transparency by bringing derivatives out of the shadows so dealers can be more easily regulated and the prices and volume of purchases and sales in the market will be readily available to counterparties. It will also ensure a better capitalized derivatives market since, as the crisis revealed, there is so little capital backing for the off-balance sheet liabilities of the large banks where the majority of the business is still being conducted. In addition, it will shrink the enormous exposure of a few very large banks that can threaten the stability of other financial institutions and the many non-financial companies that use this market.

Chairwoman Lincoln's amendment is sensible and prophylactic. It goes to the heart of the interconnectedness problem that has been exacerbated by oligopolistic market domination. Requiring a stand-alone structure for dealers will tend to encourage new entrants and bring the benefits of competition to companies that use derivatives in all sectors of the economy. If, as critics of the amendment argue, derivatives have become such a critical part of the financial system in the few decades since their invention, it is time they emerged from underground to be bought and sold in an open market. To permit the ongoing domination of an opaque market by so few banks ensures that the subsidies and bailouts needed to keep these firms viable will also be ongoing. A vote against the Lincoln amendment is a vote to perpetuate Too Big to Fail.