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Ending Interconnectedness: It’s Already in the Bill

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On the eve of the proposed debate on the Restoring Financial Stability Act reported by the Senate Banking Committee, the focus was on the weaknesses in the bill - in particular, that it didn’t do enough to prevent a repetition of a financial crisis as serious as the one we have just experienced. The bill identified and provided for a great many studies of the problems that appeared to have caused the crisis without necessarily incorporating the preventive medicine it prescribed into statute. But that particular form of weakness is already well known and a number of Senators have readied amendments to be offered on the Senate floor to strengthen the legislation.

Among those amendments, one is the Brown-Kaufman-Casey-Whitehouse-Harkin SAFE Banking Act to deal with "Too Big to Fail" (TBTF) institutions by capping banks’ size as a share of total deposits, putting limits on non-deposit liabilities of banks and non-banks as a share of GDP, and instituting a statutory 6 percent leverage ratio for bank holding companies. Another strengthening amendment was offered by Senators Merkley and Levin to ban proprietary trading by banks (the so-called Volcker Rule) through statutory restrictions rather than authorize the Financial Stability Oversight Council to develop regulations after a study. Their amendment also closes loopholes in the definition of proprietary trading, imposes higher capital standards and position limits on non-banks engaged in high-risk asset and trading strategies, and prohibits Goldman-style bets against clients by banning transactions that undermine the value, safety or performance of asset-backed securities by the firms that originate them.

But what about the other component of TBTF - the interconnectedness of the largest banks and non-banks that became so glaringly apparent when Bear Stearns, Lehman Brothers and AIG collapsed in 2008? As much as size itself, the growth in the amount of borrowing by these and other financial institutions both caused and exacerbated the crisis. Not only had they leveraged their individual and aggregate balance sheets to historically high levels but, equally important, most of the funding that supported the explosion in asset and derivative positions on and off their balance sheets was borrowed from other financial institutions. When the prices of the collateral that backed these positions began to decline, counterparties called for more collateral. Their calls forced a widening group of institutions to take charges against capital and the process of collapse began. The interconnectedness caused by the extraordinary level of borrowing by these institutions from one another resulted in a crisis that took the form of a run on the financial sector by the financial sector.

Clearly, interconnectedness is one of a critical group of related causes that helped push the system to the breaking point. Has that been forgotten? No. While it has been ignored
by those who focus on the weaknesses in the Senate bill, the fact is that the bill reported by the Banking Committee does address the problem. Section 610 of Title VI is a powerful tool that will reduce the level of systemic risk by limiting the amount of funding financial institutions can provide to one another. As a result, it will shrink the size of the largest institutions by reducing their ability to fund proprietary trading and create outsized on- and off-balance-sheet positions. Moreover, reducing the funding available for market making by the big 5 derivatives dealers that dominate the market will force most of the activity onto exchanges.

Section 610 does these desirable things by amending the National Bank Act to make the existing limits on loans to a single borrower in relation to capital applicable to credit exposures resulting from derivatives transactions, repurchase agreements, reverse repurchase agreements and securities lending and borrowing transactions. Because most of these transactions involve counterparties that are financial institutions, the amendment makes clear that the word "person" used in the Act applies to financial as well as non-financial borrowers.

The impact of this section on institutional growth is important in itself and especially so if other restrictions are not adopted. Capping the size of institutions is needed to restore a market economy by ensuring that decisions about the allocation of financial resources are not concentrated in too few hands. Much of the growth in the size of individual institutions and the financial sector as a whole is fairly recent, unprecedented and has outstripped the growth of the economy in which it was embedded. Financial sector liabilities rose from 63.8 to 113.8 percent of GDP over the decade from 1997 to 2007 (Federal Reserve System [FRS], Flow of Funds Accounts of the United States) and the six largest banks with assets of 17 percent of GDP in 1994 now have assets estimated to be over 60 percent of GDP (Simon Johnson, Baseline Scenario.com).

This amount of growth was made possible by the ability of the financial sector to monetize debt. Using assets already on their balance sheets as collateral, the largest institutions borrowed funds through repurchase agreements to buy more assets that could be used for even more borrowing. When traditional collateral such as government securities and corporate bonds grew scarce, mortgage-backed securities were used as backing. As demand for collateral grew, synthetic assets (collateralized debt obligations or CDOs) based on existing assets were created. And then came the rapid expansion of credit default swaps - a way of betting on assets owned by others that turned balance sheets into pure froth.

Over the decade of the 1990s, the market for repurchase agreements rose from about $200 billion to nearly $1 trillion and liabilities for repos accounted for 20 percent of banks' total deposits by year-end 2001 (FRS, Flow of Funds). The size of the repo market peaked at $4.3 trillion in early 2008, falling back to about $2.5 trillion currently as lenders began to require higher quality assets as collateral from borrowers. Half or more of the financial sector's liabilities for repos after 2001 were held as assets by other financial institutions. In the offshore markets, the proportion may be as high as 80 percent (Bank for International Settlements, Annual Report [various issues]). The three-fold jump in outstanding repos between the beginning of the decade and 2007 tracks the rate of growth of the largest institutions in this period, suggesting that the dramatic rise in funding within the financial sector enabled that growth. But it also culminated in an enormous web of opaque interconnections among these institutions that precipitated a credit crunch when confidence in counterparties evaporated. The vicious circle that took hold of financial markets got underway as firms' inability to fund existing positions forced sales that drained their capital and that of the system as a whole.

The incestuous nature of the build-up in funding within the financial sector must be stopped and the Senate bill takes a major step in that direction. Building on existing law to limit the credit exposure of banks to other financial institutions is a critical prophylactic measure that must be adopted to prevent on-going speculation and unsustainable growth of both institutions and the system as a whole. Moreover, it is the only way to disentangle the web of interconnections within the financial system that causes a level of contagion high enough to threaten systemic collapse.