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Ending Wall Street's Vise: It's Prevention, Stupid

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Wall Street has America in a vise and it is time to break free. As the Senate takes up financial reform legislation, bankers and other financiers, who were saved with trillions of dollars committed by American taxpayers, are spending $1.4 million per day on lobbyists and campaign contributions to gut financial reform and once again put our economy at risk. Meanwhile, the bankers are laughing all the way to the bank.

To be effective, financial reform must end the destructive cycle of financial de-regulation, financial bubble, crash, and taxpayer-funded bail-out: this is the ultimate Wall Street vise. The big banks have us cornered because they can take massive, toxic gambles, destroy their own financial institutions, and take down a host of counter-parties around the world. Then we either have to bail them out or face an even graver debacle as we saw in the aftermath of the Lehman bankruptcy filing.

The current Senate Bill ("Restoring American Financial Stability Act") presumes to end this cycle by introducing a resolution mechanism, permitting the FDIC to close down and dismantle large banks once they begin to fail. But this will not prevent them from threatening the system in the first place or causing harm when they unwind. To end the cycle and break the vise, legislation must prevent financial firms from growing too large and taking excessively risky bets that will drag us down. "It's prevention, stupid!"

Reform Worth Fighting For

Unfortunately, the current Senate bill will not fully free us from Wall Street's vise. However, it does have some components worth fighting for. In addition a number of very important strengthening amendments have been introduced that will hopefully be included in the final bill. A guide to these provisions follow:

The SAFE Banking Act to break up the banks and end "Too Big to Fail"

The SAFE Banking Act, announced on Wednesday by Senators Sherrod Brown, Ted Kaufman, Robert P. Casey, Sheldon Whitehouse and Tom Harkin, would break up the too-big-to-exist banks by imposing strict size and debt limits on banks.

The SAFE Banking Act would cap the share of total deposits that could be held by any bank holding company or thrift holding company at 10 percent. It would also create a limit on the total amount of debt, including off-balance-sheet amounts that these banks can take amass, to 2 percent of GDP. Customer deposits would not be included in this limit. Currently, for example, Bank of America holds non-deposit liabilities in excess of 7% of GDP. This would force the largest bank holding companies to shrink to no more than about $280 billion in non-deposit debt.
In addition, the SAFE Banking Act would impose a limit on overall debt, including off-balance-sheet, to 3% of GDP for certain non-bank financial companies such as large insurance firms (like AIG).

Last but not least, the Act would institute a leverage ratio. The covered institutions would be prevented from borrowing more than $16.67 for every $1 in tier-one capital. (Tier-one capital would have to be at least 6% of liabilities.) This ratio reflects a cushion, protecting against asset declines. Currently, banks can have just a 4% cushion, or $25 of debt for every $1 of tier-one capital.

**The Merkley-Levin Proprietary Trading Act: Strengthening the Volcker Rule**

This amendment would strengthen the section in the current Senate bill that incorporates the so-called Volcker Rule intended to ban proprietary trading by bank holding companies and depository institutions. Imposing such a ban is critical because it deals with the large and risky bets the major banks and investment banks make using borrowed funds to trade for their own accounts. The weakness in the existing Senate bill is that it gives great discretion to a council of regulators to develop regulations banning the practice after a study.

The Proprietary Trading Act would make the ban statutory, and would require a study of how to best implement the prohibitions. Moreover, it would close loopholes in the definition of proprietary trading so that the prohibitions would cover affiliates and subsidiaries. It would also impose limits on systemically important non-bank financial companies. The Proprietary Trading Act would also help prevent devastating abuses, such as those perpetrated by Goldman Sachs as alleged in the Abacus SEC case. It would likely do this by prohibiting originators of asset-backed securities from acting in any way that creates a material conflict of interest with investors by undermining the value, safety or performance of the securities they sell.

**An Anti-Debt Masking Amendment**

It is likely that an amendment will be offered to require reporting on the off-balance-sheet accounts of certain financial firms as part of their annual filings with the Securities and Exchange Commission. The gaps in information about these positions misled investors and regulators before the crisis and were integral to Lehman’s demise.

In addition, a requirement that firms disclose their average liabilities and leverage ratios in their periodic and annual reports and not just a period-end snapshot, as well as disclose any financings that are accounted for as sales, is necessary. This would help avoid more "repo 105" type transactions or quarter-end debt masking, designed to cosmetically improve the financial condition of a firm to mislead shareholders.

**Section 610 of the Senate Bill: Reducing Size, Interconnectedness and Corruption in the Financial System**

In Section 610 of the Senate Bill, the Senate Banking Committee provides a surprisingly powerful preventative tool that will shrink large banks by curtailing their funding, reduce the degree of interconnectedness in the system and also shrink the over-the-counter (OTC) derivatives market. It does this by making the existing limits on banks’ loans to a single borrower, in relation to capital, apply to credit exposures resulting from derivatives transactions, repurchase agreements, reverse repurchase agreements and securities lending and borrowing transactions. As a result, the ability of the large, systemically important banks to lend to or borrow from their bank or non-bank counterparties will be sharply curtailed.
The Blanche Lincoln Senate Agriculture Committee Derivatives Reform Act

The Wall Street Transparency and Accountability Act passed by the Senate Agriculture Committee is the strongest derivatives control legislation to come out of Committee during the current financial reform debate. And it is one that the largest banks, who do 85% or more of the derivatives trading, will fight to the death to kill. This bill would eliminate most of their opaque and therefore high profit margin, "customized to kill" OTC derivatives trading. In addition it would force most derivatives trading to be put on exchanges where they would have to be more transparent, less complex and therefore less dangerous. More significantly - and more distasteful to the banks - the bill requires that the banks that have access to funds from the Federal Reserve close down their derivatives (swaps) trading and put them in separate entities. The current Senate bill has some flaws: it appears to exempt foreign exchange swaps and does not force all derivatives onto exchanges, making it possible for banks to game the system.

Break the Vise

Much more must be done to truly make the financial system safe, accountable, fair and efficient: issuer-paid rating agencies have to be abolished or significantly reformed; hedge funds need to be subject to prudential regulation; new financial products have to be prohibited unless they can be shown to be safe and effective (rather than just tools for fraud, or tax and regulatory evasion); a consumer financial protection agency that is truly independent and powerful needs to be established; the Federal Reserve has to be made much more democratic; a financial transactions tax to shrink the bloated financial system has to be levied....the list could go on and on.

But there are pieces of financial reform legislation and likely amendments that are worth fighting for. They will not end Wall Street vice, which seems completely endemic to the culture of the system. But they could help break the choke hold that big finance has over the American people. And that is a vise worth smashing.