

REGULATIONS TO END 'TOO BIG TO FAIL' INVESTMENT BANKING

James Crotty, Jane D'Arista, Gerald Epstein & Jennifer Taub
University of Massachusetts, Amherst

January 12, 2010

Background

The failure or near collapse in 2008 of three of the five large independent investment banks marked the transformation of the subprime mortgage meltdown into a widespread global financial crisis. The rescues of Bear Stearns and Merrill Lynch by large bank holding company suitors required tremendous government intervention and assistance. The bankruptcy of Lehman signaled a turning point in the broader financial system breakdown. (Taub, 2009) Even the bailout of AIG appeared to be a conduit for a government bailout of the purportedly healthy Goldman Sachs which took over \$12 billion of the AIG funds, then, the largest slice of taxpayer money. (Reuters, 2009)

After Lehman failed and before the TARP money became capital infusions, in late September of 2008, Goldman Sachs and Morgan Stanley voluntarily became bank holding companies. When these investment banks took on the bank holding company designation, they also agreed to more regulatory oversight, more disclosure and higher capital reserves. Whereas the SEC had been the primary regulator of the investment banks at both the holding company level and broker-dealer subsidiary level, effective with this bank holding company designation a variety of banking regulators gained oversight powers. (Sorkin, 2008)

While this was deemed as the end of an era, questions remain as to whether the current regulatory regime or pending legislation will adequately address the problems caused by the practices engaged in by investment banking operations. Moreover, to the extent that we return to a Glass-Steagall type separation of commercial banking from investment banking and as a result, investment banks are given new designations, we must also be sure that the rules that apply to the operations fit the risks they present.

Two of the three failed institutions at the center of the current economic crisis – Bear Stearns, Lehman Brothers and AIG – were large investment banks. They and others such as Merrill Lynch, Goldman Sachs and Morgan Stanley helped to crash the system and those that remain are still dangerous because:

- they have become too big and too interconnected with other large financial institutions to be allowed to fail
- they employ excessive leverage
- they use too much short-term debt to finance longer term assets
- they engage in risky and sometimes corrupt proprietary trading that places their shareholders and customers, as well as taxpayers, at risk
- they escape national regulations by conducting some risky operations overseas

Despite these dangerous practices, the large independent investment banks were subject only to 'phantom' regulation prior to the crisis. While certain of the investment banks' business units were regulated, at the holding company level there was minimal oversight. And even now, after they have been turned into bank/financial holding companies or merged with bank/financial holding companies, their over-all regulatory framework remains insufficient to reduce to acceptable levels the systemic risks they present.

There are two inter-related imperatives that must be effectuated in order to reduce the dangers these firms pose to society: 1) End 'Too Big to Fail.' This requires that we reduce these banks' size, complexity, interdependence and scope so that a failure will not require the government to bail out the firms at taxpayer expense and 2) Reduce the risks that these systemically dangerous institutions can pose to society even if they are NOT too big to fail, since, even if they remain below the TBTF threshold, they can individually and collectively impose significant systemic risks through their behavior and interconnections if they are not properly regulated.

Regulation of investment banks can create complex issues because, as indicated at the outset, all of the largest ones are now either part of even larger complex, financial institutions or are now bank holding/financial holding companies and can become even larger and more complex institutions under current rules by merging commercial banking and investment banking activities. Hence, the first item of business that must be dealt with is to reduce the size and complexity of these organizations. The second is to strengthen regulation of investment banking activities. Both are needed to reduce the systemic dangers they pose to society.

Here we present a suggested set of rules and regulations that can be implemented to make these firms less dangerous. They include: addressing the problems of leverage, excessive short-term financing, dangerous product innovation and proprietary trading, excessive size and excessive interconnectedness. While in some respects, the measures proposed for commercial banks should apply with little or no modification to investment banks (or to the investment banking components of bank/financial holding companies) (see Americans for Financial Reform, 2009) in other respects, however, because of the different characteristics of investment banks, the measures to reduce risk must be different than those designed for standard commercial banks.

Investment Banks vs. Commercial Banks

Investment banks' dangerous practices and characteristics differ from those of commercial banks both in kind and in degree in the following key ways:

- Investment banks were more leveraged than commercial banks. At the height of the bubble in 2006, for example, investment banks such as Goldman Sachs and Morgan Stanley had leverage ratios of over 30 to 1 whereas commercial banks' ratios, though high, were around 20 to 1. (See Albrecht, 2009).
- Investment banks' liabilities were much more short term than the typical commercial banks' balance sheet liabilities even though the off-balance sheet liabilities of the larger commercial banks were also excessively short-term.
- Investment banks' business lines are different from those of all but the largest commercial banks.

Unlike traditional commercial banks, among other things they underwrite both debt and equity securities, facilitate mergers and acquisitions, engage in significant amounts of proprietary trading and the development and marketing of derivatives and other exotic financial instruments. They also finance hedge funds, finance each other and act as counterparties to a variety of market participants including those issuing 'safe' investment products like mutual funds

So in some ways, these and other differences in investment banks' structure and activities require somewhat different approaches to limiting risks, size and the complexity of these institutions.

Problems and Recommendations

There are basically three ways to reduce dangerous financial practices: 1) Ban them 2) tax them or 3) regulate them. Our recommendations below mix and match these three approaches but we do not pretend to have discovered the only or even the optimal mix. Finding the best mix can be subject to much further discussion and development.

1. REDUCE THE COMPLEXITY OF INVESTMENT BANKS

The Problem

Large complex financial institutions are too difficult to manage and to regulate, provide too many opportunities for corrupt abuse of clients and taxpayers, and have an excessive degree of political power.

Proposed Solutions

1.1 Pass a new version of Glass-Steagall legislation, along the lines proposed by Americans for Financial Reform (McGhee/AFR, 2009). From the perspective of investment banks, this would mean they and their affiliates cannot engage in commercial banking activities such as accepting deposits, and have to limit their profits from commercial banking activities such as making commercial loans. This can be accomplished by banning such activities, as in the original Glass Steagall bill. An alternative measure would be to impose the provisions or substance of the One Bank Holding Company Act Amendments of 1970 to bank and financial holding companies on the basis of size. Any such holding company that holds 5 percent of total bank and financial holding company assets must divest all subsidiaries and affiliates engaged in activities not 'closely related' to the primary activity of the holding company.

2. REDUCE LEVERAGE AND SIZE TO SAFER LEVELS

The Problem

In the build-up to the crisis, investment banks had leverage ratios in excess of 30 to 1, which is even higher than the excessive ratios (by standard measures) implemented by large commercial banks. These high leverage ratios, combined with the maturity mismatch created by over-reliance on short term borrowing discussed below, greatly contributed to the depth of the crisis. A change in 2004 to the so-called 'net capital rule' by the SEC arguably allowed these banks to acquire such enormously leveraged balance sheets (Labaton, 2008; for a different view see Sirri, 2009). On April 28, 2004, at the behest of five large investment banks including Goldman Sachs then head by former Treasury Secretary Henry Paulson, Jr. the SEC granted an exemption for broker units from leverage limits that allowed them to

invest more in credit derivatives, mortgage backed securities and other securities.

Proposed Solutions

2.1 Re-instate appropriate 'net capital' rules of 12 - 1 for assessing minimum capital requirements for all broker dealers. Furthermore, regulations should extend these rules, appropriately crafted, to all investment banks at the holding/financial holding company level. In addition regulations must close loopholes in the measurement of net capital and ban the use of ineffective and easily manipulated models of risk, such as VAR models, to determine liability limits.

2.2 Place an over-all limit on the liabilities of individual investment banks at no more than 1% of GDP.

2.3 Place a progressive tax on investment banks as they get bigger; the larger the bank in terms of assets or liabilities, the higher the rate of tax.

3. REDUCE RELIANCE ON SHORT-TERM BORROWING

The Problem

The spectacular growth of investment banks in the past two decades was fueled by borrowing from short term sources such as sale and repurchase agreements (repos) with other financial institutions, and 'security credit from households'. A repo is a transaction in which the 'borrower' sells a security to the 'lender' with the promise to repurchase it in the near future (often the next day) at a price above the sale price. This price differential generates an interest yield on the loan. The transaction is, in effect, a collateralized loan, with the security as the collateral. In 2007, according to Federal Reserve flow of funds data, net repos were 38% of total investment bank liabilities. Other estimates are higher, suggesting that up to 50% of their investments were funded in these short term markets. When the value of their assets plummeted, the safety of these investment banks was called into question. The resulting loss of confidence prompted a run on these banks by other financial institutions that threatened their liquidity and then their solvency. (Crotty, 2009).

As discussed above, this reliance on short term debt was facilitated and induced by perverse incentives created by regulatory rules and calculations that exempted the repo borrowing from leverage accounting and restrictions such as those embedded in the net capital rules (discussed above). While these transactions have the economic effect of a loan, they are treated like sales for accounting purposes.

Proposed Solutions

3.1 All debt and financing transactions, such as repos, must be on balance sheets and be properly accounted for in leverage ratios

Regulatory rules must include all borrowing and financing transactions, including short term borrowing and repos, on investment banks' balance sheets and these should be properly accounted for in making leverage assessments of banks. Rule changes might be required that take into account the fact that, while repos may not meet the legal definition of borrowing, breakdowns in these funding sources can create severe problems for broker dealers like those that occurred in 2008.

3.2 Tax short-term borrowing and financing transactions

Impose a tax on short term borrowing and financing transactions, such as repos. This tax could be structured in several different ways including:

- a) a progressive tax on short term funds so that the rate increases in steps as the percentage of assets funded with short term borrowing or financing transactions increases; or
- b) a tax based on the difference between the short term interest rate on borrowing and longer-term rates on assets financed by short-term borrowing, so as the yield-curve gets steeper, the tax rate increases.

4. REDUCE PROPRIETARY TRADING

The Problem

In recent years, investment banks have made significant and increasing amounts of profits from proprietary trading, which is using borrowed funds and their own capital for their own investment bets, rather than for the accounts of customers. This can lead to significant abuses, such as 'front running' where banks trade for their own accounts before executing trades for their customers and selling securities to customers that they believe are bad investments while profiting by betting against them - perhaps without the full knowledge of those to whom they have sold the securities. Moreover, this trading can be very risky and, under the current too big to fail doctrine, costly to taxpayers.

Proposed Solutions

4.1 Higher capital requirements on assets investment banks buy through proprietary trading.

4.2 Margin requirements on all tradable instruments (not just equities). These requirements would constrain excessive use of leverage and give the systemic regulator another countercyclical tool to dampen trading in particular assets such as mortgage-backed and other asset-backed securities as well as commodities and derivatives.

4.3 Limiting individual investment bank transactions (including repos and derivatives exposures) with financial counterparties in relation to capital. This would effectively limit the scale of proprietary trading by restricting the sources of funding. Moreover, as discussed below, it would also prevent large exposures to individual counterparties like those that created domino effects in 2008.

4.4 Imposing a tax on securities transactions to provide a disincentive for excessive trading.

5. REDUCE LEVERAGE INHERENT IN DANGEROUS FINANCIAL PRODUCTS

The Problem

Investment banks were major purveyors and buyers of risky financial products such as synthetic CDOs, mortgage backed securities and derivatives, including credit derivatives. Many of these products have a great deal of economic 'leverage' embedded in them in the sense that returns and losses can be many multiples of the original investment. Thus, in order to control the degree of leverage and riskiness of the IBs, the ability of IBs to take positions in these complex instruments must be limited.

This can be done in various ways.

Proposed Solutions

- 5.1 Significantly raise the capital requirements associated with risky engineered products.
- 5.2 Increase margin and collateral requirements associated with buying and selling such products.
- 5.3. End all over-the-counter derivatives transactions, requiring all such instruments to be sold on markets.
- 5.4 Ban dangerous financial products that have little or no social value. This shifts the burden of proof to the institutions wanting to sell new financial products to establish that they are safe and useful. (Crotty and Epstein, 2009)

6. LIMIT COMPLEX COUNTERPARTY INTERCONNECTEDNESS

The Problem

The potential failure of some large financial institutions such as Bear Stearns, Lehman and AIG had such wide spread consequences due to the dense set of interdependencies among financial institutions created through complex counterparty arrangements involving credit derivatives, complex securities such as synthetic CDOs and other complex loans and bets among financial institutions. These sets of complicated, dangerous relationships among investment banks and between investment banks and other financial institutions must be limited to safer levels. Regulating complexity is a very difficult process but one that must be undertaken. The proposals suggested so far should help significantly to limit excessive counter-party exposure: limiting or raising the cost of borrowing; banning or increasing the capital charges on producing and trading complex derivatives; limiting the amount of leverage that IBs can adopt. But these will not necessarily be sufficient. More direct limitations on counter-party exposure might be necessary.

Proposed Solutions

- 6.1 Higher capital charges to reduce excessive counterparty exposure

IBs could be required to hold progressively greater capital against counterparty exposure above certain thresholds.

- 6.2 Taxing excessive counterparty exposure

A progressive tax could be placed on counterparty exposures, as these become larger and more complex.

- 6.3 Banning dangerous types of counter-party exposure

Certain types of trades involving counter-party exposure can be completely banned including naked short selling, or naked credit default swaps, for example.

- 6.4 Limiting the amount of exposure to individual counterparties in relation to capital as discussed above.

7. RULES AND REGULATIONS SHOULD HAVE AS MUCH GLOBAL REACH AS POSSIBLE

The Problem

Investment banks will try to engage in regulatory arbitrage by moving some operations in subsidiaries or other units abroad in order to avoid these regulations. To address this problem:

Proposed Solutions

7.1 IBs must be regulated on a unitary basis That is, all operations must be reported as integrated operations of the parent company.

7.2 The reform proposals outlined above should be strongly advocated by the Administration at global fora such as the Financial Stability Board and G-20 discussions.

References

- Acharya, Viral V. and Matthew Richardson, eds. 2009. *Restoring Financial Stability; How To Repair a Failed System*. New York: Wiley Finance.
- Albrecht, Mathew B. 2009. *Industry Surveys: Investment Services*. Standard & Poor's, November 26.
- Americans for Financial Reform, 2009. <http://ourfinancialsecurity.org/2009/12/preventing-the-next-financial-crisis-and-bailout-too-big-to-fail-policy>
- Crotty, James. 2009. "The Bonus-Driven 'Rainmaker' Financial Firm: How These Firms Enrich Top Employees, Destroy Shareholder Value and Create Systemic Financial Instability." Political Economy Research Institute (PERI), www.peri.umass.edu/safer
- Crotty and Epstein. 2009. "A Precautionary Principle for Finance: New Rules for Financial Product Safety," Political Economy Research Institute (PERI), www.peri.umass.edu/safer_resources
- D'Arista, Jane. 2009. "Proposals to Regulate Proprietary Trading" Safer Policy Note #2, Political Economy Research Institute (PERI), www.peri.umass.edu/safer
- Demos. 2009. "A Brief History of the Glass-Steagall Act." www.demos.org
- Labaton, Stephen. "Agency's '04 Rule Let Banks Pile Up New Debt," *New York Times*, October 3, 2008.
- Reuters. 2009. "Q&A with Goldman Sachs over AIG Bailout," March 17, 2009. www.reuters.com/article/idUSN1729956620090317
- Sirri, Erik R. "Remarks at the National Economists Club: Securities Markets and Regulatory Reform," U.S. Securities and Exchange Commission, www.sec.gov/news/speech/2009/spch040909ers.htm
- Sorkin, Andrew Ross and Bajaj, Vikas, "Shift for Goldman and Morgan Marks the End of an Era," *New York Times*, September 21, 2009. <http://www.nytimes.com/2008/09/22/business/22bank.html>
- Taub, Jennifer. 2009. "Enablers of Exuberance: Legal Acts and Omissions that Facilitated the Global Financial Crisis," www.peri.umass.edu/safer_resources