

Credit Allocation Policies to Advance Financial Stability and Social Welfare

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Abstract: Pollin asks “How do we design measures that are capable of promoting both financial stability and broadly-shared social welfare?” One element of the framework he envisions is an asset-based reserve requirement, which would require financial institutions to maintain a cash reserve proportional to the riskier assets in their portfolios. Pollin lays out the history of such requirements and the mechanisms by which they create stabilization in financial markets and create incentives for banks to make channel funds towards socially desirable economic activities.

In undertaking the task of rebuilding a viable financial system in the aftermath of the 2008-09 Wall Street meltdown, the principle that should guide all discussions should be straightforward: how to design measures that are capable of promoting both financial stability and broadly-shared social welfare.

One policy tool that has demonstrated its effectiveness by both standards is asset-based reserve requirements. These are regulations that require financial institutions to maintain a supply of cash as a reserve fund in proportion to the other, riskier assets they hold in their portfolios. Such requirements can serve both to discourage financial market investors from holding an excessive amount of risky assets, and as a cash cushion for the investors to draw upon when market downturns occur. Such regulations can also be used to require financial institutions to channel a share of their total lending into areas of the economy that would be most effective in advancing social welfare and environmental sustainability.

This policy idea has an extensive, if largely neglected, mainstream pedigree. Various versions of this proposal were outlined in the 1970s by economists such as Lester Thurow of MIT and former Federal Reserve Governors Andrew Brimmer and Sherman Maisel. Their interventions were more or less closely linked to unsuccessful efforts by Sen. William Proxmire and Rep. Henry Reuss, then chairs of the Senate and House Banking Committees, respectively, to advance bills establishing procedures for Federal Reserve-directed credit allocation policies. In addition, measures that operate similarly to asset-based reserve requirements have been implemented and have played prominent roles in regulating financial markets.

One example of a regulation already on the books that closely resembles an asset-based reserve requirement are the so-called margin requirements on stocks purchased with borrowed funds. Through margin requirements, market speculators who borrow money to purchase stocks are forced to carry a percentage of this new debt as cash with their brokers.

In fact, during the dotcom bubble of the late 1990s, then-Federal Reserve Chair Alan Greenspan acknowledged that he could have controlled what he himself had termed the market’s “irrational exuberance” through raising margin requirements. At the meeting of the Federal Reserve’s Open

Market Committee on September 24, 1996, Greenspan stated, “I guarantee that if you want to get rid of the bubble...[raising margin requirements] will do it.” But Greenspan was not willing to confront Wall Street at that time. A simple proposal would therefore be for government regulators, beginning with the Federal Reserve Chair, to actually make use of this policy tool as the next incipient bubble begins to form. The overarching idea here would be to channel credit to productive investments within the United States in which risks can be relatively well understood, and correspondingly to discourage speculative investments where risks are relatively opaque.

An example where the same basic principle of an asset reserve requirement has been used to promote social welfare was with the Savings & Loan institutions, as they operated in the U.S., from the 1930s-1970s. Under the old Glass-Steagall financial regulatory system created in the 1930s, S&Ls were permitted to only lend money to households to finance the purchase of private homes. This requirement channeled massive pools of credit toward supporting the goal of middle-class home ownership, and everything that goes with that.

In today’s economy, asset reserve requirements could be used to channel credit into, for example, clean-energy investments. As I have and my co-authors have recently shown, investments in a clean energy economy have the capacity to also be a major engine of decent job creation and poverty reduction in the United States (see, for example, [Green Prosperity: How Clean Energy Policies Can Fight Poverty and Raise Living Standards in the United States](#)). Policymakers could stipulate, for example, that at least five percent of the loan portfolios of financial institutions should be channeled to clean-energy investments. In terms of the economy in 2007--i.e. before the 2008-09 financial meltdown--this would amount to about \$150 billion per year (relative to about \$3 trillion in total loans made by U.S. financial institutions that year). This is a bit less than one percent of total GDP and eight percent of total private investment as of 2007.

If the financial institutions fail to reach this five-percent quota of loans for clean-energy investments, they would then be required to hold this same percentage of their total assets in cash. The banks would therefore not necessarily have to meet the five percent low-clean energy threshold, but they would have a strong incentive to do so rather than to hold cash, which would generate no interest for them.

Overall, asset reserve requirements offer the opportunity for public policy to exercise significant social control over major finance and investment activities while still allowing considerable decision-making freedom for both financial institutions and non-financial businesses. The financial institutions, for example, would still be responsible for establishing the creditworthiness of businesses and the viability of their projects. The businesses would still be responsible for the design and implementation of their investments. Indeed, business would still have the freedom to pursue non-preferred projects, and banks could still finance them. Financing costs would just be significantly higher.

To bring additional flexibility, the requirements could be implemented, as suggested by former Fed Governor Maisel, as a system of market auctions rather than quotas. Through an auction system, institutions would not be required to carry the specified proportion in loans in preferred sectors as stipulated (for example, again, five percent in clean energy investments). Financial institutions holding more than the required level of preferred assets in their loan portfolios would obtain permits that

they could then sell to institutions whose portfolios are below the stipulated standards. Individual institutions could therefore choose to maintain particular market niches. At the same time, the system would ensure that some niches carried an extra burden--if an institution chose not to meet the preferred-sector lending standard, they would either have to carry a greater level of cash reserves or they would have to purchase permits from institutions that are willing to sell them.

Details aside, the basic features of this proposal can be summarized quite simply. They include:

1. *Universal Coverage.* Asset reserve requirements should be applied to all financial institutions operating under U.S. legal jurisdiction, whether they are called banks, holding companies, hedge funds, or variations thereof, and regardless of the national origin of an institution or individual.
2. *Requirements.* The requirements should be established according to two criteria:
 - A. *Financial Stability.* As with margin requirements that apply to security brokerage firms, all financial institutions would be required to hold a higher percentage of cash reserves relative to the share of speculative assets in their portfolios.
 - B. *Social Welfare.* Financial institutions would be able to hold a lower percentage of cash reserves relative to the proportion of loans they have made in high-priority areas of the U.S. economy. One clear example here would be the one cited above: investments in clean energy, which are also effective means of promoting decent employment and poverty reduction.

Properly designed asset reserve requirements, then, can achieve several important objectives of reform. Even as they promote financial stability, asset reserve requirements that apply to all financial institutions can promote important social goals.

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