Leverage, Proprietary Trading and Funding Activities

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Overview of the problem:

Rising leverage was a significant part of what went wrong in 2007. Large institutions used leverage to expand the size of trades for their own account (proprietary trading) and borrowed through repurchase agreements to finance their positions. The scale of mounting leverage was exacerbated by deregulation – in particular, the Financial Services Modernization Act (Gramm, Leach, Bliley) of 1999 that permitted banks to borrow in order to fund traditional and nontraditional financial investments and the SEC's relaxation of the leverage ratio for investment banks from $12 to over $30 for each $1 of capital. The rise in financial sector debt from 63.8 to 113.8 percent of GDP over the decade from 1997 to 2007 is a telling indicator of how leverage had bloated the system and made it vulnerable to systemic risk (Federal Reserve, *Flow of Funds)*.

Leveraged borrowing for proprietary trading increased risk in the system while leaving it critically undercapitalized. Risk to capital was increased as banks and investment banks had the capacity to book their trading accounts off balance sheet where they were not monitored by regulators or scrutinized by credit rating agencies. Trading for their own (rather than customers') accounts increases an institution's profits (and employees' compensation) without making any contribution to the real economy. It also creates conflicts of interest as it puts financial intermediaries in competition with their customers. Anticipating changes in market prices based on information about clients' orders to buy or sell, institutions face no restrictions if they engage in "front running" by trading for their own accounts before executing trades for their customers.

Repurchase agreements increase systemic risk by intensifying the interconnectedness of financial institutions. From 2001 to 2007, repurchase agreements used as a source of funding for commercial and investment banks, finance companies and hedge and private equity funds jumped three-fold from $788 to $2, 364.8 billion with over half of the borrowing and lending involving other financial institutions (Federal Reserve, *Flow of Funds)*. How the complex web of counterparties created by intra-sectoral borrowing contributed to systemic risk was dramatically demonstrated by the threat the collapse of Lehman Brothers posed for other financial institutions and the degree of government intervention it prompted.

Proposals for Regulation:

In order to prevent a repeat of the financial crisis we must contain leverage across the system and constrain the potential for bubbles. We propose the following regulatory tools to deal with problems caused by leverage, proprietary trading and the concentration of borrowing and lending within the financial sector:

Lower leverage limits. Re-impose leverage limits at the lower levels that prevailed for banks before 1999 and for investment banks before 2004 and extend them to all systemically important institutions such as finance companies and hedge and private equity funds. Lower leverage limits would curtail the scale of proprietary trading by constraining the ability to fund large positions.

Securities transactions tax. A Tobin tax on securities transactions would also be an effective tool for dampening the level of proprietary trading.

Limits on loans to other financial institutions. This extension of existing law would reduce the level of interconnectedness that fuels contagion in the system.

Imposing margin requirements on purchases of all financial instruments. Extend margin requirements applicable to purchases of stocks to all major credit market instruments such as mortgage- and other asset-backed securities.

Most of the above proposals reflect the kind of regulatory framework that was dismantled by deregulation and is now being reconsidered. They provide a framework that favors rules over discretion and rejects a regulatory approach that has permitted adherence to belief in the equilibrating power of market forces to become an excuse for self-regulation.