

REGULATIONS TO END “TOO BIG TO FAIL” INVESTMENT BANKING

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

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

Although the survivors have become bank holding companies, 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. While in some respects, the measures proposed for commercial banks should apply with little or no modification to investment banks (IBS) in other respects, because of the different characteristics of investment banks, the measures to reduce risk must be different than those designed for standard commercial banks. There are two inter-related imperatives that must be effectuated in order to reduce the dangers these firms pose to society. First, end “Too Big to Fail” (TBTF). 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. Second, 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.

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

- Pass a new version of Glass-Steagall legislation. 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.

2. Reduce Leverage and Size to Safer Levels

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

- Regulatory rules must include all borrowing and financing transactions on investment banks' balance sheets, including short term borrowing and repos, and these should be properly accounted for in making leverage assessments of banks.
- Impose a tax on short term borrowing and financing transactions, such as repos.

4. Reduce Proprietary Trading

- Place higher capital requirements on assets investment banks buy through proprietary trading.
- Require margin requirements on all tradable instruments (not just equities) which 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.
- Limit 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.
- Impose a tax on securities transactions to provide a disincentive for excessive trading.

5. Reduce leverage inherent in dangerous financial products

- Significantly raise the capital requirements associated with risky engineered products.
- Increase margin and collateral requirements associated with buying and selling such products.
- End all over-the-counter derivatives selling, requiring all such instruments to be sold on exchanges.
- 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.

6. Limit Complex Counterparty Interconnectedness

- Require IBs to hold progressively greater capital against counterparty exposure above certain thresholds to reduce excessive counterparty exposure.
- Tax excessive counterparty exposure. A progressive tax could be placed on counterparty exposures, as these become larger and more complex.
- Ban dangerous types of counter-party exposure including naked short selling and naked credit default swaps.
- Limit the amount of exposure to individual counterparties in relation to capital.

7. Rules and Regulations should have as much global reach as possible

- IBs must be regulated on a unitary basis, that is, all operations must be reported as integrated operations of the parent company.
- The reform proposals outlined above should be strongly advocated by the Administration at global venues such as at the Financial Stability Board and in G-20 discussions.

References

Crotty, James; Jane D'Arista; Gerald Epstein and Jennifer Taub. 2010. "Regulations to End 'Too Big To Fail' Investment Banking." Political Economy Research Institute, January.