Dēmos

THE FUTURE OF REGULATION
REPORT SERIES

policy brief

Six Principles for True Systemic Risk Reform

Deregulation Has Brought us to "Too Big to Fail"

Ten years after the capstone of financial industry deregulation—the Financial Modernization, or Gramm-Leach-Bliley, Act—the United States is facing the worst economic crisis since the Great Depression. Dēmos is working to restore common sense financial regulations that would have prevented the current crisis and will pave the way for a more prosperous and stable economy in the long-term. Comprehensive and meaningful systemic risk reform must undo many of the ill-advised deregulatory measures[1] of the past 20 years, including the four key changes wrought by the Gramm-Leach-Bliley Act, signed on November 12, 1999:

1) The Act repealed the final lines created by the Glass-Steagall Act of 1933 to segregate commercial banks from the inherently riskier investment banks, allowing the aggregate institutions to become bank holding companies benefiting from government protections including access to cheap loans from the Fed.

2) The Act also erased the lines created by the Bank Holding Act of 1956 to divide insurance companies from banking institutions.

3) The Act allowed bank holding companies to apply for a newly expanded status: "financial holding companies," which still enjoy government protections but are more loosely regulated, with lower capital requirements and greater leeway to speculate and conduct non-financial activities.

4) Finally, the Act allowed certain types of derivatives transactions to trade outside of regulated exchanges, giving birth to, among other things, the unregulated credit default swap market.

How to End "Too Big to Fail"

The size and scope of today's biggest, most complex financial institutions has led to unfair subsidies and bailouts, made prudent management nearly impossible and exposed the entire global economy to risk. It is time for Congress to create a framework for banks to transform themselves into leaner, more accountable and sustainable financial institutions. Six principles for this new framework are:

1) **Banks Cannot Be Hedge Funds.** The rise in risk-inflating activities by former commercial banks—now bank and financial holding companies—has jeopardized the safety and soundness of our entire banking system. When the Gramm-Leach-Bliley Act invited investment institutions to become bank and financial holding companies, it exposed taxpayers to liability for their bad bets. The government does and should guarantee the safety of the banks that

1. Other highlights in deregulatory missteps include: the Commodity Futures Modernization Act of 2000 prohibiting the CFTC from regulating over-the-counter derivatives; the Private Securities Reform Litigation Act of 1995 restricting corporate accountability for securities fraud, and the Federal Reserve's decades-long refusal to enforce the Home Owner Equity Protection Act of 1994 against subprime lenders.

serve consumers, small businesses and the real economy; however, it should not back over-leveraged, risky bets that solely benefit Wall Street. It is time for banks to be banks again. Institutions that wish to engage in more speculative activity can do so, but without government protection. **Similar to the original Glass-Steagall Act, institutions that choose to remain bank or financial holding companies should have 18 months to reduce the percent of their income that comes from securities (and any type of derivative products origination and trading) to 10 percent, with one year to present a plan to do so.**

2) **Restrict Proprietary and Off-Balance Sheet Trading.** In the decade since Gramm-Leach-Bliley loosened restrictions on intra-bank borrowing, commercial banks have joined investment banks and hedge funds in using massive amounts of debt to fund their own investment strategies. This "proprietary trading" stacked additional profits and risk on top of the banks' regular customer service-based income, helping banks compete with highly-leveraged hedge funds and publicly-traded Wall Street investment firms. Additionally, banks could record profits and hide debt from speculative activity off their balance sheets, where it was unmonitored by their regulators or even credit ratings agencies. Proprietary trading, even in the form of gathering assets for CDOs and other packaged products, has also created dangerous conflicts of interest, as banks compete for market advantage against their own customers (while benefiting from access to information about their trades). **Restricting proprietary and off-balance sheet trading and leveraging would reduce the more systemically risky competitive desires between commercial and investment banks that drive them to merge into institutions that are too big, or to take the kinds of leveraged risks that drive short-term profits at the expense of long term financial system stability.**

3) **Lower Wall Street's Credit Limit.** Financial sector debt ballooned from 63.8 percent of our nation's GDP in 1997 to an astonishing 113.8 percent of GDP in 2007. Along with Gramm-Leach-Bliley's deregulation of intra-bank borrowing, the SEC helped accelerate this unhealthy level of leverage by raising investment banks' leverage limit in 2004, from 12-to-1 to 30-to-1. This short-sighted deregulatory measure helped fuel the housing and securitization boom that came to its inevitable bust last year. **Lowering the leverage limit of all financial institutions, including the finance arms of private equity and hedge funds, would reign in the riskiest bets and keep the financial sector in line with the health of the real economy. In addition, capital reserve requirements should be increased in proportion to the size of the institution.**

4) **Bring Back Competition.** Today, two banks, Bank of America and Wells-Fargo, are above 10 percent deposit concentration limits, and JPM Chase is close to 10 percent. Competition was the principal argument for deregulation in 1999; however, the industry has become only more consolidated and anti-competitive. The largest, "too big to fail" banks now enjoy an even larger competitive advantage from both outright government assistance and the superior credit terms afforded by investors anticipating perpetual government support. **Congress should immediately instate lower deposit concentration limits on the banking industry to discourage further consolidation. The Fed must either perform its duty to enforce these limits, or surrender enforcement power to the FDIC or another body that shows itself capable of performing this basic regulatory function.**

5) **Democratize the Fed.** The U.S. Treasury's systemic risk proposal would put even more power and discretion in the hands of the Federal Reserve—without improving its integrity, accountability or transparency. The nation's most powerful banks are currently able to dictate significant regulatory policy

(as well as the flow of Fed financing to firms) through their direct control of who governs the Federal Reserve Banks. Banking institutions not only choose their regulators, but in many instances, *are* their regulators, as bank directors and officers take positions within the Federal Reserve System. Notorious levels of secrecy have also allowed the Fed to contribute to the most damaging bubbles of our deregulated era. Financial regulatory reform must include Federal Reserve reform. **The selection process for the regional Federal Reserve Banks must be reformed to ensure that the power rests with publicly accountable officials—not just bank executives. In addition, bank directors and senior officials should be barred from leadership positions within the Federal Reserve System. Finally, lessening the banks' influence over the Fed should also help the agency adopt goals to strengthen the broader economy, not just the industry—such as the control of asset bubbles and full employment.**

6) **Protect Investors and Consumers, Protect the System.** The current banking crisis proves that deregulation aimed at weakening consumer and investor protections ultimately increases systemic risk. During the 90s, regulators adopted a "hands off" approach to subprime mortgages in the face of fierce bank lobbying against regulating predatory mortgages—and the resulting crisis of poor underwriting and unaffordable consumer loans brought Wall Street to its knees. Investors and consumers suffered in the short-term from the regulatory gaps that allowed shadow banking and unregulated mortgage finance companies to grow unchecked, but in the final accounting, the entire financial system bore the cost. **Proposals to create comprehensive regulation of derivatives and other elements of the shadow banking market must go hand-in-hand with true systemic risk reform. In addition, a robust Consumer Financial Protection Agency with non-preemptory jurisdiction over all financial products will help realign incentives in a system where the fate of consumers and lenders are ultimately intertwined.**

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