
FINANCIAL NEWS



Cutting through the systemic risk muddle

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It was a long week for Davos Man, oozing about trying to determine the future of international banks, but not learning much. Everyone is for improving the system, but so far actions have been limited to taxing bank bonuses and signifying broad agreement that something has to be done.

[Bank of England](#) Governor [Mervyn King](#) praised the US for its efforts to initiate financial reforms, but American regulatory watchers are pulling their hair out over the highly politicised and unfocused sausage factory that the process has become.

The [House of Representatives](#) passed a reform bill in December close to what the Administration requested, but more attention was paid to providing a new [Consumer Financial Protection Agency](#), and regulating derivatives and executive compensation than to systemic risk.

This is to be left to the [Federal Reserve](#) to manage, bolstered by greater intervention powers for dealing with the few large non-bank financial institutions that are left, though the Fed's past record of regulating systemic risk is far from good.

The companion bill introduced to the Senate banking committee last November, which has challenged the role of the Fed as chief regulator, has not gone anywhere yet. Early indications are that it may have trouble attracting the 60 votes needed to assure passage; Fed chairman Bernanke's reappointment barely squeaked through last week.

Since the Republican victory in the special election in Massachusetts last month, passage of a Senate bill this year has become doubtful.

Meanwhile, to encourage his supporters, President [Barack Obama](#) announced a 10-year \$117bn Financial Crisis Responsibility Fee to be paid by largish banks and insurance companies to recover government losses on troubled asset relief programme loans to [AIG](#), the auto industry and smaller banks.

The President wants to "get our money back", he said, though those required to pay the fee do not

actually have much of it. The President has also announced his intention to impose the Volcker rule (a year after it was first proposed by former Fed Chairman [Paul Volcker](#) and then ignored). This rule would limit the ability of large banks to take on proprietary trading and related risks, but how this will happen depends on details not yet announced.

The Treasury, which never liked the Volcker rule, leaked a plan to allow bank holding companies with few deposits but considerable proprietary activities (ie [Goldman Sachs](#) and Morgan Stanley) to be exempted from the rule.

In a more sensible place than today's America, systemic risk regulation would be given top priority and treated separately from lesser reforms demanded by political leaders – the world has suffered from two speculative bubbles that have involved systemic failures in the past 10 years and is likely to do so again unless an improvement in the world's ability to contain systemic risk is put into effect.

The US Government needs to take the lead in devising a simple way to do this. The programme should address four issues:

- Windfall profits tax.

The many market support and subsidisation programmes undertaken over the past year have provided a substantial financial windfall for those firms able to benefit from them. A one-off tax on windfall profits would be a fair way to treat the abnormal gains from intervention, guarantees or special treatment and would reduce funds available for bonuses, which may comfort those who have objected to them.

Such a tax (though generally a bad idea) has been proposed by some commentators in the US and the UK, but the US Government has not pursued it. It should.

- Too big to fail insurance.

Many academics and others (including Volcker) have objected to the moral hazard associated with bank bailouts. Governments have essentially given away their implied guarantees of bank non-deposit liabilities, which benefit those too-big-to-fail firms. An effort should be made to determine the value of this guarantee and to charge the cost of it to those who profit from it, the way federal deposit insurance works.

The cost of the insurance, should be fairly steep considering the size of the largest banks, and it should discourage them or other large financial firms from expanding their balance sheets further. But in any case, the taxpayer would be taken off the hook – in future any bailouts would have to come from the banks' insurance fund. The Financial Crisis Responsibility Fee, which is nonsense, should be scrapped.

- Incentives for banks to break themselves up.

Increased capital reserves and restrictions on leverage and liquidity should also be required of these large institutions, such that they would be discouraged from maintaining large proprietary trading or investing because they could not compete effectively with non-too-big-too-fail hedge or private equity funds not subject to the new rules.

To these might be added a Volcker rule to limit any trading activity beyond short duration marketmaking, to improve the prospects for large banks restructuring themselves into less complex and accident-prone units by spinning off their riskier businesses into smaller enterprises that would not be too big to fail.

- Make the system internationally compatible.

The plan has to be something that other countries can adopt so as to create an internationally consistent system and the best way to do this is through the Basel Committee, which has been working on revised minimum bank capital adequacy standards and knows the issues. The committee should adopt an insurance plan and Volcker rule too.

These steps do not amount to government increasing its involvement in private sector activities as they protect the private sector from being dominated by a few large, aggressive financial firms.

Breaking these firms up into failure-tolerant sizes would encourage private sector competition, and involve less risk of unwanted government bailouts than what we now have. And it would keep the US Government out of the business of favouring one set of banks over another. Republicans and free market capitalists should love such a plan.

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