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# FINANCIAL NEWS



## Will US finance bill reduce systemic risk?

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**The final, amended version of the Senate's financial reform bill is not yet available but from what we can see from the press and other sources, the Lincoln amendment on derivatives and the Dodd/Shelby amendment preventing taxpayer funds from being used for any future bailout without prior congressional approval have been retained, and the Volcker rule has been restored.**

Large financial firms will be subject to systemic risk regulation (including enhanced capital requirements) and the requirement to provide "living wills" for their unwinding, if necessary. The Financial Consumer Protection Bureau housed within the [Federal Reserve](#) has survived considerable tweaking and has remained in place. The \$50bn bank-paid dissolution insurance fund has been dropped and the \$90bn bank tax proposed by President [Barack Obama](#) to restore troubled asset relief programme losses, and a provision for securities marketmaking to become a fiduciary duty were not adopted. The bill has to be reconciled with the financial reform bill passed by the House last December.

There is some expectation that the Obama administration will request modification of the amendment on derivatives to be more practicable and less likely to either drive the derivatives business offshore or to remove from the market a number of hedging devices necessary in today's risk management environment. Otherwise, it is assumed, reconciliation around the terms of the Senate bill is likely to occur within the next few weeks.

Does the Senate bill improve the government's ability to manage a crisis of systemic risk in the future? It is hard to see how it does.

It does provide intervention authority in the case of systemically important non-banks, though the government acted swiftly to intervene in the market run against [Bear Stearns](#), [AIG](#) and [Merrill Lynch](#) in 2008, and might have assisted a sale of Lehman Brothers to [Barclays](#) Bank, but chose not to. These interventions, along with those of [Fannie Mae](#) and [Freddie Mac](#), protected the creditors of the firms so as to provide for assurances to the market that the many hundreds of billions of dollars of their liabilities, owned by financial institutions all over the world, would not suddenly (as in the case

of Lehman) become nearly worthless, setting off a stampede for the exits and a total collapse of global financial markets. This fear, after all, was what drove Henry Paulson, [Ben Bernanke](#), Timothy Geithner and their international counterparts to the actions they took to save the system from a fate even worse than the disagreeable act of bailing out private sector investors. Bailouts are always the lesser of two evils, but without them it is hard to see how a true economic disaster in 2008 could have been avoided.

However, the new intervention powers are only for the purpose of liquidating the distressed firms (after a cumbersome two/three vote of the high-level committee designated to oversee financial regulatory actions), in a process similar to bankruptcy proceedings but with no temporary use of government funds without prior approval by Congress. Yes, that would avoid future unpopular bailouts, but at what cost to the economic and financial system? Should the Federal Reserve have acted in 2008 instead to liquidate AIG, Merrill Lynch and probably [Citigroup](#) (as well as [General Motors](#) and GMAC) with creditors paying their full share of the cost?

The Lehman Brothers bankruptcy alone created havoc in financial markets for four months and this was only stemmed by vigorous and unprecedented interventions by the Fed in the interbank, commercial paper, term loan and mortgage markets. The total cost of the interventions to stem the tide after Lehman was several trillions, yet the net cost to taxpayers resulting from intervention in all of the large systemically important financial institutions, after their repayments, is not expected to be large at all, and may result in a profit to the government. (The Tarp may run a loss of \$90bn or so but mainly from smaller, non-systemic banks and the auto industry).

The reappearance of the Volcker rule, requiring banks to end their proprietary trading, hedge fund and private equity activities may include some loopholes, but is, on the whole, appropriate for systemically important firms, which should not be allowed (as Citigroup, [UBS](#), Merrill Lynch, Lehman Brothers and Bear Stearns were) to take large market risks on proprietary investments. De-risking these banks is a constructive idea; they can spin off these businesses to their shareholders. But even if they do, the surviving systemic banks will still be very large, some with trillion-dollar balance sheets even after the haircut. Nothing in the reform bill requires banks to become smaller, or discourages their becoming even bigger as undoubtedly many will as they are encouraged by regulators unable to bail out distressed banks, to acquire other, failing large banks, as was done with [JP Morgan Chase](#), [Bank of America](#) and [Wells Fargo](#). Very large banks have trouble managing all the different risks they carry, and periodically one or another of them fail at it.

On the whole, the task of confining risk in systemically important banks is left to the regulators, by their scrutiny, to perform. Such scrutiny, whether by the various US regulators or their European counterparts, did nothing to prevent the last crisis – bubbles are often thought to be “trends” before they burst – and nothing in the Senate bill suggests that their ability to prevent a systemic crisis in advance of its happening is likely. Neither is much to be expected from Basel III, a well-meaning but slow and generally not very effective form of assuring minimum capital adequacy for banks internationally.

Is there some good in the bill? Actually there may be. After the Senate bill was passed, large banks everywhere began to scratch their heads asking what they might have to do to adapt to it. The various costs of the bill could substantially reduce return on investment while at the same time increase their cost of capital, thereby questioning the economic efficacy of their business models. Some will no doubt decide to restructure themselves into somewhat different businesses. These are likely to be less systemic risk-intensive, which is a good thing. The more this risk is de-concentrated from among the 20 or 30 large firms in the world that presently carry it, the better the system will be able to manage it.

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