There Is a Way Governments Can Protect Banks too Big to Fail

by **WHYTE DAIMIN INVESTMENTS LIMITED**

Limiting risk-taking by bankers and regulating the use of derivatives is crucial to preventing the collapse of the global financial system. The 36-page US Banking Act of 1933 was effective in limiting both commercial banks' securities activities and affiliations between commercial banks and securities firms. Its 1999 repeal facilitated the growth of the unregulated global derivatives trading markets and the financial crisis the world is still suffering. The Dodd-Frank Act's "Volcker Rule" comes into effect in 2015. It seeks to limit risk-taking by banks in over 900 pages of complex provisions.

However, *The Wall Street Journal* has reported, "No executive at a major bank complained all that much about the 'Volcker Rule' during fourth-quarter conference calls with analysts." Goldman Sachs' CFO said, "We don't see anything in the rule that prevents us from continuing to hedge." JP Morgan Chase's CFO said its impact on profits will be "relatively modest." If nothing has really changed, how are new financial crises being prevented?

Forbes magazine predicts, "Another global financial crisis is on the way. Financial reform didn't work. Banks today are bigger and more opaque than ever, and they continue to trade in derivatives in many of the same ways they did before the crash, but on a larger scale and with precisely the same unknown risks. Derivatives trading now totals in notional amounts more than US$700 trillion. The market has grown so unfathomably vast that the global economy is at risk of massive damage should even a small percentage of contracts go sour."

JP Morgan Chase reportedly has US$69.9 trillion in derivatives positions. When one of its derivatives traders lost US$6.2 billion, its chairman characterized it as a "tempest in a teapot." According to a US Congressional investigation the bank has manipulated portfolio values to hide losses, breached credit limits and manipulated risk measures. The bank has paid fines and legal costs of US$31.78 billion since 2009. But for it, they are just a cost of doing business, and when it settles such cases, its stock price and market capitalization rise. The status quo is not an effective deterrent of illegal conduct.

Government bailouts have increased the moral hazard and risk of the financial system's collapse posed by bankers who have incentives to enrich themselves by gambling with bank assets at taxpayers' expense. When the bets don't pay off bankers carry on in their existing or other jobs. In the financial crisis 8.8 million jobs were lost in the US; an estimated 52 million were lost worldwide.

According to *Forbes*, "Bankers generally assume that the likely risk of gain or loss on derivatives is much smaller than their 'notional amount'. However, it is possible to lose a large portion of the 'notional amount' of a derivatives trade if the bet goes terribly wrong, particularly if the bet is linked to other bets, resulting in losses by other organizations occurring at the same time. The ripple effects can be massive and unpredictable. Banks don't tell investors how much of the 'notional amount' they could lose in a worst-case scenario, nor are they required to. Even a savvy investor who reads the footnotes can only guess at what a bank's potential risk exposure from the complicated interactions of derivatives might be. And when experts can't assess risk and large bets go wrong simultaneously, the whole financial system can freeze, leading to a global financial meltdown."

The *Financial Times* says, "It is time to admit defeat. The bankers have got away with it. They have seen off politicians, regulators and angry citizens alike to stroll triumphant from the ruins of the great crash. Some thought the shock of 2008 might change things. We were fools. Bankers are still collecting multimillion-dollar bonuses even as they shrug off multibillion-dollar fines. We are all a lot poorer. Yet on Wall Street and in the City of London, it is business as usual."

But it is certainly not "time to admit defeat". "Business as usual" urgently needs to be changed. A key issue is whether bankers operating globally can do whatever they want with the reliable expectation of huge personal gain and impunity? Chinese law limits the use of derivatives and puts business decision-makers at the epicentre of scandalous socially-damaging behavior on trial and in jail. None of the top decision-makers at US banks at the epicentre of the global financial crisis has been prosecuted. Is that because everything they did was legal under US law, which was unable to prevent the global financial crises? Or is it because US banks are too powerful to be effectively regulated?

What is clear is that new, effective global regulation of derivatives trading and tougher prohibitions and policing of bankers' risk-taking are essential. Anat Admati and Martin Hellwig argue, in *The Bankers' New Clothes*: What is Wrong with Banking and What to Do About It, that the way to reduce the danger of another systemic crisis is to raise bank capital requirements far above Basel III levels. Campbell Harvey concurs, saying, "This is the time to look deeply, fundamentally, structurally, at what we can do that might have been considered radical a year or two years ago. What can we do, not just to survive the next six or twelve months, but to build long-term strength?" Hopefully, the World Economic Forum's 2015 Global Risk Report will present and promote a Bankers' New Clothes-based design of an effective global regulatory system capable of protecting banks too big to fail from themselves.

Sidebar

Martin Hellwig

Anat Admati

Anat Admati is the George G. C. Parker Professor of Finance and Economics at Stanford's Graduate School of Business and serves on the FDIC Systemic Resolution Advisory Committee. Martin Hellwig is director at the Max Planck Institute for Research on Collective Goods and was the first chair of the Advisory Scientific Committee of the European Systemic Risk Board and the co-winner of the 2012 Max Planck Research Award for his work on financial regulation. *The Wall Street Journal* said, "Ms. Admati and Mr. Hellwig, top-notch academic financial economists, do understand the complexities of banking, and they helpfully slice through the bankers' self-serving nonsense. Demolishing these fallacies is the central point of *The Bankers' New Clothes*."

"The past few years have shown that risk-taking in banking can impose significant costs on the economy. Many claim, however, that a safer banking system would require sacrificing lending and economic growth. *The Bankers' New Clothes* examines this claim and the narratives used by bankers, politicians, and regulators to rationalize the lack of reform, exposing them as invalid. Admati and Hellwig argue we can have a safer and healthier banking system without sacrificing any of the benefits of the system, and at essentially no cost to society. They show that banks are as fragile as they are, not because they must be, but because they want to be and they get away with it. Whereas this situation benefits bankers, it distorts the economy and exposes the public to unnecessary risks. Weak regulation and ineffective enforcement allowed the buildup of risks that ushered in the financial crisis of 2007-2009. Much can be done to create a better system and prevent crises. *The Bankers' New Clothes* calls for ambitious reform and outlines specific and highly beneficial steps that can be taken immediately." (Princeton University Press)