FINANCIAL PRODUCTS: WHAT SUPERVISION? WHAT NOTATION? WHAT GUARANTEES?

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Dr. Ronald W. Cornew
Market Consulting Corporation, Miami, Florida
rcornew@market-consulting.com

In my remarks here today I am going to discuss the steps that have been taken as well as those still to be taken in an attempt to secure adequate supervision of the financial markets of the world in the era following the financial crisis of 2007-8. These remarks follow exactly one year to the day my comments at the 2009 CIFA conference in which I talked about how the financial crisis followed a 40-year period in which government--and particularly the American government--had progressively destabilized the economic and financial system of the world prior to Bear Stearns, Lehman, Citigroup, AIG and others precipitating the immediate crisis.

I further commented that day on the steps then being proposed to deal with the crisis in Europe and America. It is that subject to which I now wish to return in order to see what progress has occurred.

FINANCIAL PRODUCTS: WHAT SUPERVISION?

My remarks last year ended with a cartoon which is a suitable beginning point for the comments this year. See Figure 1.

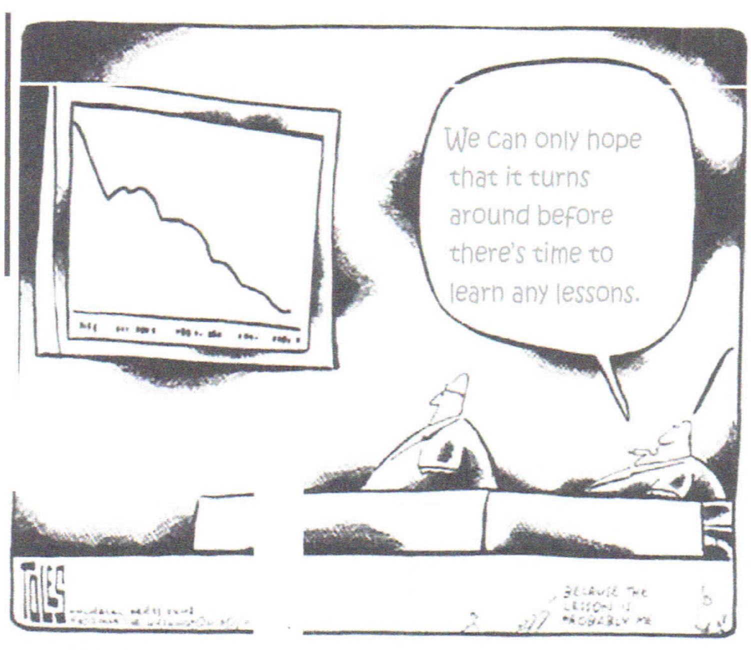

Figure 1 - Interestingly it was not until 1933 that Glass-Steagall was passed, resulting in an almost four-year delay from the stock market crash of 1929 until the full extent of the lessons of this period became

known. It was only when Judge Ferdinand Pecora was appointed by President Roosevelt and held hearings in that year that America learned the full extent of the greed that had consumed Wall Street and others in the investment community. To date President Obama has ordered no such investigation of the current collapse which may impair the effort to achieve important financial reforms.

In following events over the last year it has often seemed that the financial situation was righting itself and, given enough government money, that further financial reform was either unnecessary or would not occur. The stock market has recovered to a significant degree, and the sense of malaise that hung in the air as recently as 6 months ago has largely departed except perhaps for recurring worries related to Greece and Italy and Ireland, and problems here in Spain and Portugal, which serve to remind us that world unemployment remains high, and full economic recovery does not appear possible until large numbers of people return to the work force whose purchasing power has been sorely missed. We also do not know what the effects on the economy and the markets will be when the stimulus begins to be pulled away. Already the recession of last year--which continues in many parts of the world--has grown to the longest in living memory. See Figure 2.

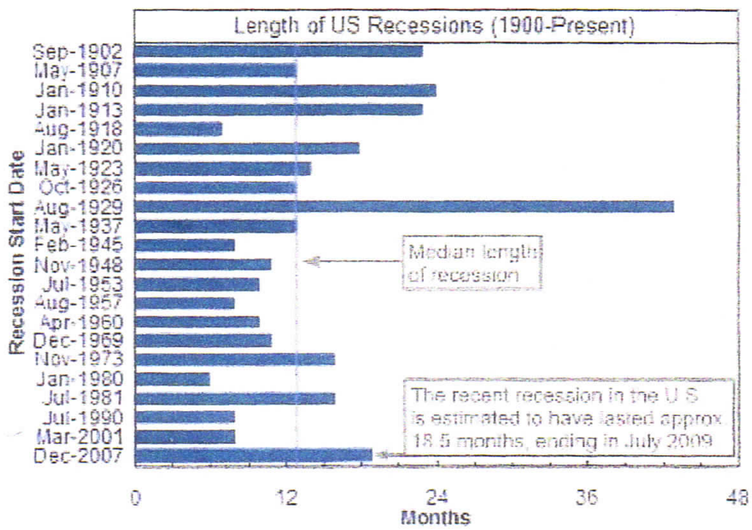

Figure 2 - Here the lengths of U.S. recessions since 1900 are plotted. The 2007-09 recession was well beyond median length and longer than any recession since the Great Depression. The estimate for its length is attributable to the U.S. Federal Reserve Bank in Minneapolis although there continues to be uncertainty on this point in some quarters.[1]

In pondering these things it is worth considering that the principle reforms associated with the Great Depression did not occur immediately. The Securities Act of 1933 in the United States which regulated the underwriting of stock offerings, was 4 years in occurring after the 1929 market crash, and was followed a year later by the Securities Exchange Act of 1934 which regulated the exchanges and the secondary market for stock transactions. The Investment Advisors Act and the Investment Company Act did not follow until 1940.

[1] "U.S. Economist Dissents, Saying Recession Is Over", The New York Times, April 12, 2010, <http://www.nytimes.com/2010/04/13/business/economy/13recession.html>

This time around the stage was set for potential reform much sooner as political change--the inauguration of Barack Obama as President of the United States in 2009--followed the crisis almost immediately rather than lagging by four years (1929 to1933 when Franklin Roosevelt became President). While this foreshortening would auger for a more sudden change it should be recalled that the number of potential areas for reform is much greater this time. With this said, let us review the report card of the Obama administration to date and see if the stimulus package has appeared to have derailed the process of regulatory change.

Securities Exchange Commission: the Uptick Rule

One area in which change has already resulted is a new uptick rule effective in about 30 days. Prior to July, 2007, the U.S. already had in place a rule that required naked short-selling to occur only after an uptick in the price of a stock had occurred. In place for 70 years and dating to Depression-era reforms, most Americans had believed that this rule together with Federal Reserve rules limiting margin borrowing had been responsible for the increase in safety in the American stock market after the 1930s. The new rule was adopted by the Securities Exchange Commission (SEC) under its new Chairman Mary Schapiro only after months of public input which produced 4300 written comments.[2] This new uptick rule functions much like the old one except that it requires an upward movement of 0.125 in the best national bid which is the decimal equivalent of the previous 1/8. However, unlike the previous rule, it is only triggered if the stock price has already fallen 10% within the day. This "circuit breaker" idea has been adopted from the circuit breakers which are now applied to the market as a whole on down days to shut off or limit trading. It is the source of most negative comment about the rule as it is felt that a would-be short seller, or group of short sellers, intent on driving the price of the stock down need only distribute their selling pressure over a number of days to achieve the same effect in destroying a company. It should be remembered that Bear Stearns was destroyed over a 13 day period in 2007 immediately after the original uptick rule was removed. Critics contend that 13 days is a more-than-adequate period to destroy a stock if it can be knocked down 10% each day. However, the circuit breakers could function effectively by dissipating the *unremitting* aspect of short selling during a bear raid on a stock, and giving would-be buyers a chance to regroup.

Commodity Futures Trading Commission: Position Limits and Margin Revisions

The Commodities Futures Trading Commission (CFTC) under its new Chairman Gary Gensler proposed rules on January 1, 2010 that would set position limits on certain exchange traded energy futures contracts traded in the U.S. at the New York Mercantile Exchange (NYMEX) and the Intercontinental Exchange (ICE).[3] It has also proposed changes to the margin

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[2] "SEC Approves Short Selling Restrictions", <http://www.sec.gov/news/press/2010/2010-26.htm>

"Securities and Exchange Commission curbs short sales", <http://www.marketwatch.com/story/sec-votes-3-2-for-alternative-uptick-rule-2010-02-24>

"SEC Votes For Alternative Uptick Rule", <http://www.hedgefund.net/publicnews/default.aspx?story=10967>

"On short sales, SEC needs to save stir-crazy investors", <http://www.nj.com/business/index.ssf/2010/03/on_short_sales_sec_needs_to_sa.html>

"How Well Is She Protecting You?", Money Magazine, March 2010, pp. 108-111.

[3] "Stopping Speculators: CFTC Putting Oil Trading on ICE?", <http://currents.westlawbusiness.com/Articles/2010/02/20100225_0020.aspx>

limits for speculative Off-Exchange Retail Foreign Exchange Transactions.[4] While the comment period for these rule changes is only now drawing to a close it is clear that Gensler has taken up the cause of regulation with a zeal. He is as well pushing for exchange trading with centralized clearing for standardized Over-the-Counter (OTC) derivatives to be regulated by the CFTC. In remarks before the Futures Industry Association in Boca Raton, Florida on March 11[5], he indicated that he was seeking a "comprehensive regulatory framework governing over-the-counter derivatives" that would apply to "all dealers and all derivatives, including interest rate swaps, currency swaps, foreign exchange swaps, commodity swaps, equity swaps, credit default swaps and any new product that might be developed in the future". First, derivative dealers would be explicitly regulated for the first time and would be required to post capital "to protect the public from bearing the cost" if they failed. Second, standardized OTC derivatives would be traded on exchanges or other trading platforms to allow price discovery and public transparency. Recall that during the financial crisis no one had a price reference for certain assets and their derivatives that then came to be known as "toxic". Finally, where standardization is possible, derivatives should be cleared through clearing houses where the obligation of the counter parties can be guaranteed. Finally, to mitigate against the inclusiveness imposed by banks and other financial organizations who "benefit from opacity and inefficiencies", these facilities should be open for all who seek to use them.

As a side light it should be noted that this is the same Gary Gensler who, while working for Goldman Sachs, lobbied successfully to keep regulation of swaps out of the Commodity Modernization Act of 2000 thereby contributing to the lack of regulation that allowed AIG to create the credit default swap fiasco which cost American taxpayers $180 billion dollars in Troubled Asset Relief Program (TARP) money, and led to enumerable other problems at investment banks like Bear Stearns, Lehman Brothers, Citibank, Merrill Lynch, Bank of America, Goldman Sachs and others who imagined that the magic of "dark" derivatives had somehow insured them against loss.[6]

"Testimony before the Commodity Futures Trading Commission", Cota, Sean, July 28, 2009, <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/hearing072809_cota.pdf>

[4] Szala, Ginger, "Leveraging Free Speech", Futures Magazine, March 2010, p. 8

[5] Remarks of CFTC Chairman Gary Gensler, OTC Derivatives Reform, Future Industry Association's Annual International Futures Industry Conference, Boca Raton, Florida, March 11, 2010, <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/speechandtestimony/opagensler-33.pdf>

"OTC Swaps Clearing Must Be Open To All firms, Gensler Says", <http://www.businessweek.com/news/2010-03-11/otc-swaps-clearing-must-be-open-to-all-firms-gensler-says.html>

"CFTC's Gensler Takes His Message On Credit Derivatives To Europe", <http://www.nasdaq.com/aspx/stock-market-news-story.aspx?storyid=201003160414dowjonesdjonline000108&title=cftcs-gensler-takes-his-message-on-credit-derivatives-to-europe>

[6] "Goldman Deal-Maker Now Advocates Regulation", The New York Times, March 10, 2010, <http://www.nytimes.com/2010/03/11/business/11cftc.html>

In the United States a battle appears to be shaping up over the regulation of OTC derivatives including Credit Default Swaps (CDS) with both the CFTC and SEC staking out turf.[7] Chairman Schapiro hopes that resolution will follow along the lines of the Shad-Johnson accord of the 1980s with the SEC regulating all swaps based on underlying securities, while the CFTC regulates all commodity-based swaps. But the CFTC has greater regulatory experience with *derivatives* and a mind-set that is appropriate to high-leverage instruments which the SEC lacks and so might be a better regulator of all swaps. Also unclear is the extent to which insurance regulators will be allowed into the picture. CDSs are, after all, a form of insurance. The Frank bill proposes a new Federal Office of Insurance where previously insurance regulation was an exclusive provenance of state regulators who, regrettably, have only now sought to exert their influence and regulatory muscle.[8]

CHRISTOPHER DODD: REGULATORY PROPOSALS IN THE U. S. SENATE

Christopher Dodd, as Chairman of the Senate Banking Committee, has just unveiled the most comprehensive reform of the American banking industry and its capital markets since the 1930s.[9] Announced on March 15 his financial reform bill

- restricts proprietary trading by banks as suggested by ex-Federal Reserve Chairman Paul Volker. This forces banks to use assets for true banking purposes such as lending and restricts their ability to establish or fund hedge funds. This thereby greatly lowers the risk in banking as it has been practiced in recent times.
- requires investment banks to maintain a participatory interest in securities they create and sell. No longer would they be able to create pools of, say, subprime mortgages and market the same without maintaining at least some participation in the pool.

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[7] “Stronger regulation would help bring financial swaps out of the shadows”, Schapiro, Mary, The Washington Post, April 2, 2010, <http://www.washingtonpost.com/wp-dyn/content/article/2010/04/01/AR2010040102801.html>

[8] “Credit Swaps Move Closer to Regulation With N.Y. Plan “, Bloomberg.com, <http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=akmnbe4McIsI#>

“State Initiatives to Regulate Credit Default Swaps Deferred Pending Federal Action”, Campbell, Leah and Choi, Robin, <http://www.metrocorpcounsel.com/current.php?artType=view&EntryNo=10049>

[9] “Sen. Dodd to unveil updated legislation to overhaul financial regulatory system”, The Washington Post, March 11, 2010, <http://www.washingtonpost.com/wp-dyn/content/article/2010/03/11/AR2010031102005_pf.html>

“Going out like a lion”, MarketWatch, March 16, 2010, <http://www.marketwatch.com/story/chris-dodds-reform-effort-his-own-legacy-2010-03-16>

“Senate panel seen approving financial reform”, Reuters, March 16, 2010, <http://www.reuters.com/article/idUSTRE62F4YB20100316>

“Meet The New Financial Regulations Chris Dodd Just Proposed”, <http://www.businessinsider.com/meet-the-new-financial-regulations-chris-dodd-just-proposed-2010-3>

“Revised bill puts reform on track”, Financial Times, March 15, 2010, <http://www.ft.com/cms/s/0/8b82f7b0-3074-11df-bc4a-00144feabdc0.html>

“Where was Moody’s board when top-rated bonds blew up?”, McClatchy Washington Bureau, April 2, 2010, <http://www.mcclatchydc.com/2010/04/02/91419/where-was-moodys-board-when-top.html>

- gives the SEC the power to discipline the rating agencies like Moody's, Fitch's and Standard & Poors when they fail to properly rate the quality and risk of investments. This problem of "notation", or "credit rating" as it is known in Europe, played an important part in producing the financial crisis and is a vitally important part of any reform.
- creates a consumer financial protection agency within the U.S. Federal Reserve and gives it the task of protecting American consumers against faulty financial products just as they already have protection against contaminated food, faulty appliances and dangerous toys.
- ends "too big to fail" (TBTF) by proposing a systemic risk control council which would monitor financial institutions for early indications of excessive risk, and would be empowered to sell or close down such institutions. There would be a $50 billion fund to pay for future bailouts. This would be the extent of U.S. government "guarantees" to such institutions.
- includes a framework for the regulation of OTC derivatives.

Given the size and scope of the bill--it runs to 1336 pages--substantial criticism is inevitable although some of these reforms are likely to pass this year as Republican opposition has not been so great as that toward, say, healthcare reform.[10] Among the notable criticisms are the placement of the consumer protection agency within the Federal Reserve which has traditionally been charged with protecting banking interests. Critics prefer a stand-alone agency. It is also thought that the restrictions on proprietary trading by banks together with limits on their ability to fund hedge funds may also make them uncompetitive with European and Asian institutions which are not so limited. Further criticism centers on the delays in bringing a bill forward when risk is making a comeback through delayed regulation of derivatives with no abatement (yet) in the dangers of credit default swaps. Troubled assets and troubled institutions remain, and plans for their regulation and orderly demise are arguably needed immediately.

The bill also does not address what is perhaps the biggest fault of all: that off-balance sheet transactions would continue to be permitted so that the balance sheets of financial institutions are today a fiction which few persons, if any, can correctly unravel to give even a glimpse of the true financial health of our banks and corporate institutions. According to one author, the following balance sheet of a major U.S. bank from its annual reports illustrates the complete fictionalization that off-balance-sheet derivatives have brought to accounting. See Figure 3.

[10] "AARP Supports New Consumer Protection Agency", <http://bulletin.aarp.org/yourworld/politics/articles/aarp_supports_new_consumer_protection_agency.html>

"Wall Street Reacts to Sen. Christopher Dodd's Financial Reform Bill", <http://www.dnainfo.com/20100316/financial-district-battery-park-city/wall-street-reacts-sen-christopher-dodds-financial-reform-bill>

"Dodd 2.0: Maybe we need to reboot", The Washington Post, March 17, 2020, <http://www.washingtonpost.com/wp-dyn/content/article/2010/03/16/AR2010031604208.html>

	2006	2007	2008	2009
Assets	$1,884	$2,188	$1,938	$1,889
Liabilities	$1,765	$2,074	$1,797	$1,746
Equity	$120	$114	$142	$142

Figure 3 - In fact, this balance sheet belongs to Citigroup. Here "there is not even a hint in these numbers that the value of Citigroup's business went from a quarter of a trillion dollars to nearly zero. There is no indication that Citigroup suffered massive losses in 2007 and 2008, and then a major post-rescue recovery in 2009. Instead, the balance sheet suggests that Citigroup's was steadily and consistently healthy for all four years. This balance sheet is, in a word, fiction." [11]

BARNEY FRANK: ACTIONS IN THE U.S. HOUSE OF REPRESENTATIVES

The House Financial Services Committee chaired by Representative Barney Frank of Massachusetts has responded to Senator Dodd's proposal by publicly stating

> "Senator Dodd has put forward a thoughtful, comprehensive bill which will, once the Senate has acted on it, form a very solid basis for a House-Senate conference to produce the tough regulatory reform that President Obama has rightly asked for."[12]

Privately he is known to favor an *independent* Consumer Financial Protection Agency (CFPA), a complete end of TBTF, an executive compensation system which gives shareholders a "say on pay", regulation of hedge funds and a Federal Insurance Office to monitor all aspects of the insurance industry. His insistence in strengthening the Dodd bill may lead to a vote having to be taken in the U.S. Senate where, unlike healthcare, he predicts a required 60th Republican vote will be found to help secure passage of a stronger bill.[13]

Both the Dodd and Frank bills contain provisions for the registration and regulation of hedge funds, which hitherto has not been required in the United States. The Frank proposal was approved by the House of Representatives in November, 2009, which represented an early success of the Obama administration's efforts to achieve comprehensive financial reform.

FINANCIAL PRODUCTS: U.S. PARITY WITH EUROPE

The G20 conference in Pittsburgh in September, 2009, created an anticipation that whatever regulatory order came into existence on one side of the Atlantic would be matched by a similar

11 Partnoy, Frank, "The Dodd Wall Street Charade" The Daily Beast, March 15, 2010, <http://www.thedailybeast.com/blogs-and-stories/2010-03-15/dodds-flawed-wall-street-bill/>

12 "Frank Statement on Senator Dodd's Financial Reform Package" House Committee on Financial Services, March 15, 2010, <http://www.house.gov/apps/list/press/financialsvcs_dem/pr_031510.shtml>

13 "Barney Frank Not Happy With Senate's Regulatory Compromise", <http://www.prospect.org/csnc/blogs/tapped_archive?month=03&year=2010&base_name=barney_not_happy_with_senates>

system of laws and regulations on the other. However, with so much undecided by this date one wonders how such a thing is likely to result and what shape it will take. True, no one said such structures would be identical, only that they would work together in a complementary fashion. If we meet again in a year from this date, perhaps we will then be able to both discern what regulatory change has happened in America and also begin to see where compatibility will be found. After all, the current Greek crisis and the role played by derivatives in the problem there is likely to keep attention high on the derivatives situation in Europe.[14] It stresses the need for common *international* solutions to creating a transparent regulatory structure so that no *government or other institution* can hide over-expenditure or loss. The current difficulty in finding common ground on the issue of regulating hedge funds in the U.S. and Europe notwithstanding, we have common problems that need common solutions, albeit ones that differ in particulars.[15]

Principle areas of concern for where harmonization appears desirable but elusive include hedge fund regulation, the related area of derivative speculation including the "dark ocean" of speculation in CDSs and capitalization of banks.[16] All have been making headlines in Europe in recent weeks.

HEDGE FUND REGULATION

The news here has been of a split between EU-proposed regulation of hedge funds under the proposed Alternative Investment Fund Manager Directive, and Britain which is home to 80% of the industry in Europe.[17] As you are probably aware the U.S. and Canada have sided with Britain

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[14] "Strike mutes Greek business", Granitsas, Alkman, The Wall Street Journal-Europe, March 12-14, 2010, Vol. XXVIII, No. 30 PP. 1 & 4

[15] "IMF: chance to overhaul global economy is receding", White, Aoife, AP, March 17, 2020, <http://www.google.com/hostednews/ap/article/ALeqM5jt6BMLbbL353kzg8BK_8Y4-CxMQQD9EGEBN02>

[16] "Regulators worry over cracks in financial reforms", Reuters, March 17, 2010, <http://www.reuters.com/article/idUSTRE62G3ED20100317>

[17] "European Union finance officials at impasse on global reform", The Washington Post, March 17, 2010, <http://www.washingtonpost.com/wp-dyn/content/article/2010/03/16/AR2010031603247.html>

"EU battle over hedge funds goes global", The Wall Street Journal, March 12, 2010, <http://online.wsj.com/article/SB40001424052748703625304575115822566374604.html>

"Geithner Not Happy With European Hedge Fund Proposal", HedgeFund.net, March 11, 2010, <http://www.venturecapital.net/publicnews/default.aspx?story=11036>

"U.S., Europe at odds over global financial reform", The Washington Post, March 13, 2010, <http://www.washingtonpost.com/wp-dyn/content/article/2010/03/12/AR2010031204321.html>

"UK says hedge fund rules must be agreed globally", Reuters, March 16, 2020, <http://www.reuters.com/article/idUSLAH00671720100316>

"EU rejects US claims of hedge funds regulation rift", EurActiv, March 12 (updated March 15), 2010, <http://www.euractiv.com/en/financial-services/eu-rejects-geithner-s-claims-regulation-rift-news-330649>

"US warns EU of financial reform clash", EurActiv, March 17, 2010, <http://www.euractiv.com/en/financial-services/us-warns-eu-financial-reform-clash-news-348532>

"MFA backs Geithner's stance on EU draft regulations", Hedge Funds Review, March 12, 2010, <http://www.hedgefundsreview.com/hedge-funds-review/news/1596152/mfa-backs-geithner-s-stance-eu-draft-regulation>

over the need for changes in the plan proposed by EU ministers with the English-speaking countries fearing that proposed regulations to hedge funds would prevent them from marketing in Europe. Regardless of the merits, when an earlier proposal for a "passporting" system which would have allowed such funds to sell on the continent provided there was "equivalence" between regulatory rules in the fund's domicile and the EU was replaced by a provision allowing non-EU funds to market in EU states only if "cooperative arrangements" exist between *individual* member states and the regulators in *both* the country in which the hedge fund is domiciled and where it is managed.

As this requirement shifts the approval for a particular fund to gain a "passport" from agreement between the EU countries as a whole and their domiciled nation to agreements among three nations including the Caymans where regulation has been light and unlikely to be seen as "equivalent" by individual EU member nations, the hedge fund industry feels that it may be shut out from EU markets. U.S. Treasury Secretary Timothy Geithner has described the more recent proposal as "protectionist". The EU ministers have tabled action on the proposal until June in order to attempt to find common-ground, and we are unable to now report that either U.S. or EU regulators have successfully developed regulations to register or regulate hedge funds, let alone to develop a mutually agreeable scheme for "convergence" of approved regulation.

DERIVATIVE SPECULATION

News from Greece together with other heavily-indebted nations such as Portugal, Italy, Ireland and Spain has again brought to the forefront fears about debt and the use and misuse of derivatives by important companies and, indeed, even nations who have attempted to hide their true financial condition.[18] Lurking in the background is also the fear that speculators could bring

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"EU pulls hedge fund curbs, amid British opposition", EUbusiness, March 17, 2010, <http://www.eubusiness.com/news-eu/finance-economy-us.3mo>

[18] "I.M.F. chief calls for European 'fire brigade'", Saltmarsh, Matthew, The Global Edition of The New York Times, March 20-21, 2010, p. 9

"Greek play Act VI, El País (English Edition with the International Herald Tribune), March 20, 2010, p. 7

"Eurozone Crisis: Will PIGS Get A Blanket???", Caploe, David, EconomyWatch, <http://www.economywatch.com/economy-business-and-finance-news/eurozone-crisis-will-PIIGS-get-a-blanket-06-02.html>

"Gambling on Greek Finances", Malhotra, Heide B., Epoch Times, March 16, 2010, <http://www.theepochtimes.com/n2/content/view/31524/>

"Europe Unifies to Assist Greece with Line of Aid", The New York Times, April 12, 2010, <http://www.nytimes.com/2010/04/12/business/global/12drachma.html>

"Wall Street Helped to Mask Debts Shaking Europe", The New York Times, February 14, 2010, <http://www.nytimes.com/2010/02/14/business/global/14debt.html>

"It's Time for Swaps to Lose Their Swagger", The New York Times, February 28, 2010, <http://www.nytimes.com/2010/02/28/business/economy/28gret.html>

"Lehman Hid Money With help of Global Rules", The New York Times, March 16, 2010, <http://www.nytimes.com/2010/03/17/business/17views.html>

"Leipzig in legal wrangle with banks over CDS", Financial Times, March 20-21, 2010, p. 9

entire nations to ruins by short-selling "bear raids" on their national debt comparable to what occurred with Bear Stearns and Lehman Brothers stock. Greek premier George Papandreou has already alleged that such activity has raised the cost for Greece to borrow. While the implications of the large debts facing these nations may threaten the European monetary union, and have set off a considerable debate over the role of the IMF vis-à-vis EU member nations collectively helping these debtor nations, underlying currency swap transactions have grown to approximately $13 trillion dollars by June 2008 from only about $600 million in 2001. Of course, this is only a part of the growth of the underlying "dark ocean" of unseen OTC derivative trading (which has been estimated at $680 trillion dollars in face value and $20 trillion in market value by 2008[19]). Against this backdrop, the European Commission (EC) will be making a proposal for dealing with CDSs and their naked selling including a possible ban on such activity by speculators, however improbable opponents argue it would be to find and maintain sufficient market liquidity were that to occur.[20] U.S. regulators oppose this approach as doomed to fail.

SIZE AND CAPITALIZATION OF BANKS

Less in the news, but still vitally important, is progress with BASEL III and with banking reform in general.[21] It will be recalled that certain earlier BASEL accords are largely blamed in the U.S. for the failure of Bear Stearns and Lehman Brothers in that U.S. investment banks were able to use their lack of appropriate standards for capital reserves to convince the SEC in April 2004 to remove net capital rule restrictions on them on the theory that they needed to compete internationally. This paved the way for the failure of both institutions with capital ratios--that is, the ratio of capital to assets--at about 3%. This is to be contrasted with a 6% ratio for U.S. commercial banks--which are less risky--below which point the U.S. Federal Depository Insurance Corporation (FDIC) begins to monitor the bank for soundness. At 3% the FDIC would be well on the way to arranging a take-over for a commercial bank were its ratio to have dropped so low. For historical purposes we again include an historic profile of the capital ratio of U.S. banks. See Figure 4.

"Credit Default Swaps: SEC Asks Congress To Regulate Trades Happening 'In The Dark'", The Huffington Post, March 12, 2010, <http://www.huffingtonpost.com/2010/03/12/credit-default-swaps-sec-_n_496764.html>

"EU pulls hedge fund curbs, amid British opposition", EUbusiness, March 17, 2010, <http://www.eubusiness.com/news-eu/finance-economy-us.3mo>

[19] "Semiannual OTC derivatives statistics", Bank for International Settlements, <http://www.bis.org/statistics/derstats.htm>

[20] However, the CDS transactions are also huge, totaling more than $50 trillion dollars in face value and approximately $3 trillion in market vale by June, 2008. See Gillian Tett, *Fool's Gold: How the Bold Dream of a Small Tribe at J.P. Morgan Was Corrupted by Wall Street Greed and Unleashed a Catastrophe*, New York: Free Press, 2009.

[21] "EU Barnier: Better Regulation Needed For Market Confidence", iMarketNews.com, <http://imarketnews.com/node/10400>

"E.C.B. chief presses for stricter rules for banking", International Herald Tribune, March 13-14, 2010, p. 1

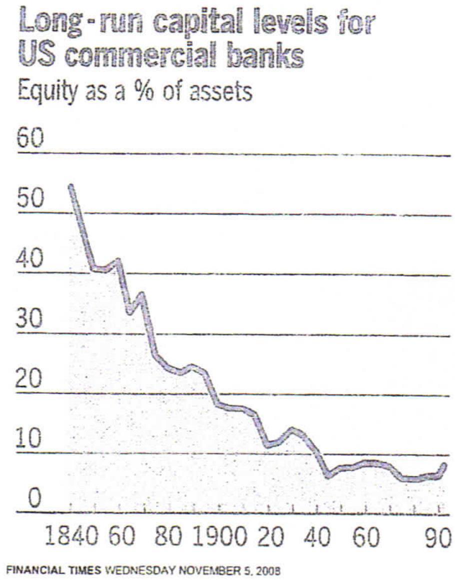

Figure 4 - In 1840 banks lent out only about 2 times their equity while in the more recent period it has ranged from ten to sixteen times (corresponding to 6 to 10 percent on the graph). Bear Stearns and Lehman were at more than 30 to 1 when they failed although they were in a riskier business than commercial banks.

As if reacting to all this, BASEL III has been criticized as too severe in its recommendations on liquidity and capital in its December, 2009, reforms. The capping of bank leverage in the same general area for both U.S. banking institutions and those in Europe is important to maintain a level playing field for banks worldwide. By November the Financial Stability Board (FSB) plans to come out with a proposal on TBTF in an effort to prevent further bailouts by taxpayers. The danger here is that U.S. and European regulators will reach divergent solutions to common problems, and thereby encourage "regulatory arbitrage" by banks and potential future financial instability. Do we want another crisis or do we wish to use this period as the best opportunity in this century to achieve regulation that is both effective, and world wide in its scope? If the latter goal can be achieved, the resulting economic efficiency will allow greater economic growth and enhance the ability to pay off the debts undertaken by government to contain this crisis and to allow the survival of most of our financial institutions. This so however much their faults may have presented the world with this great problem. For contrast, see Figure 5 for how the U.S. got out of a similar debt crisis after World War II through another alternative…inflation. The unemployment in America records the human misery resulting from the failure to adequately regulate the banking industry. See Figure 6.

In *13 Bankers*, Simon Johnson, former Chief Economist of the International Monetary Fund and now at the Massachusetts Institute of Technology, has written about the problem resulting from the consolidation of banks in recent times which has only been accelerated by the recent financial crisis.[22] He argues that in America an oligarchy in banking now exists, and that the U.S.

[22] Johnson, Simon and Kwak, James, *13 Bankers*, Knopf Doubleday Publishing Group, March 2010.
"Contradicting Secretary Geithner", The Huffington Post, April 2, 2010,
<http://www.huffingtonpost.com/simon-johnson/contradicting-secretary-g_b_523073.html>

can not implement a TBTF policy without breaking up the banks into sizes such that failure of individual institutions is again possible. Surprisingly, Alan Greenspan, who as Chairman of the U.S. Federal Reserve Bank was a strong advocate of limited bank regulation, presaged this current wave of enthusiasm for breaking up the largest U.S. banks by saying in October, 2009, "If they are too big to fail, they are too big".[23] It remains to be seen what influence these ideas which are now growing in influence in America will have in Europe.

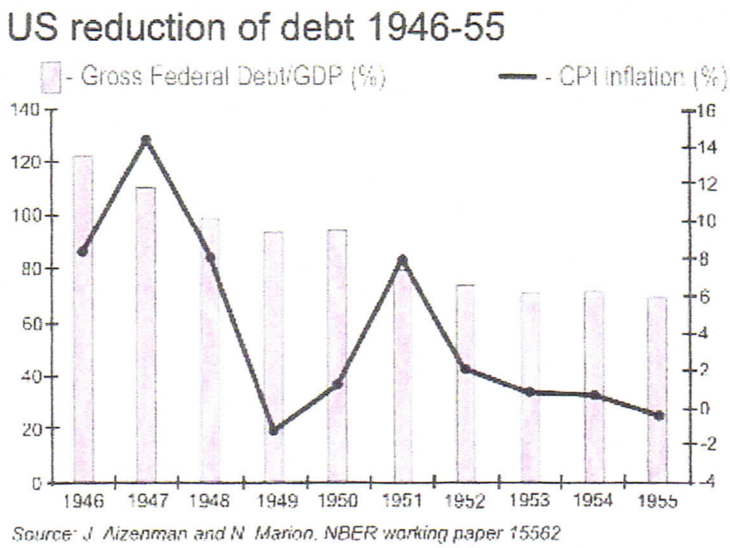

Figure 5 - In the period from 1946 to 1955 after World War II, the Gross Federal Debt-to-GDP ratio dropped by about 50%. With an average debt maturity of 9 years in 1946 and an average inflation over the 1946-55 period of 4.2% (including the 1947 spike to 14.4%), inflation alone reduced the 1946 ratio by almost 40%.

"MIT's Johnson Says Too-Big-to-Fail Banks Will Spark New Crisis", Bloomberg.com, March 21, 2010, <http://www.bloomberg.com/apps/news?pid=20601088&sid=agtzzM.WMObI>

"Books@DailyFinance: Too Big to Fail = Too Big", DailyFinance.com, 4/1/2010, <http://www.dailyfinance.com/story/books-daily-finance-too-big-to-fail-too-big/19422136/>

"Book Club Pick: Why *13 Bankers* is a Must-Read for Barack Obama, Chris Dodd, and Everyone Who Wants to Avoid Another Financial Crisis", The Huffington Post, April 7, 2010, <http://www.huffingtonpost.com/arianna-huffington/book-club-pick-why-i13-ba_b_529409.html>

[23] "C. Peter McColough Series on International Economics: The Global Financial Crisis: Causes and Consequences", Council on Foreign Relations, October 15, 2009, <http://www.cfr.org/publication/20417/>

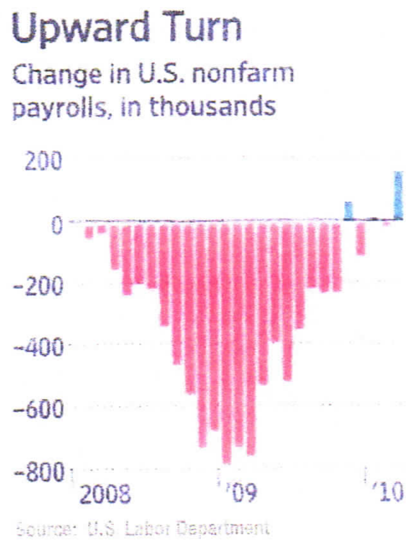

Figure 6 - The aggregate payroll loss in the U.S. over the recent recession was on the order of 8.5 million jobs. Although recent employment figures show some upticks into positive territory, a significant portion of this gain can be attributed to part time jobs and temporary hiring by the Federal government to conduct the country-wide 2010 Census.