

Is this the Minsky Moment for Reform of Financial Regulation?

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I. A Minsky Moment? (or a “senior” moment?)

The recent instability in the mortgage markets, driven by the securitization of sub-prime and Alt-A mortgages was initially characterized by some market analysts as a “Minsky Moment”. In March of 2007 the Chairman of the Federal Reserve considered “the impact on the broader economy and financial markets of the problems in the subprime markets seems likely to be contained.” Yet a relatively small one trillion dollar sector of the mortgage market soon became a crisis of the entire US financial system and in the words of Treasury Secretary Paulsen that was “the worst financial crisis in the nation’s history.”² This more general crisis was also baptized a “Minsky Moment”. To paraphrase a well-known US Senator from Illinois, a moment here, a moment there, and soon are talking about real crisis.

Those who are acquainted with Minsky’s work will recognize that his approach had little to do with “moments”. It was about the sustained, cumulative processes in which periods of stability induce an endogenous increase in potential financial fragility that provided a fertile ground for financial instability that could lead to a process of debt deflation. This was the basis for the argument that the initial sub-prime crisis was not the result of a Minsky process of increasing financial fragility, but rather the result of a simple Ponzi scheme that was preprogrammed into non-conforming mortgages.³ While their development may have been part of a longer-term process, their fragility was not. On the other hand, Minsky’s analytical framework, based on analyzing cash receipts and cash commitments, proved to be a particularly appropriate tool for understanding that these mortgages were Ponzi schemes from their creation and thus preordained to generate financial instability.

The fact that the sub-prime crisis was able to spread to the rest of the financial system and set off a full scale bout of systemic instability and debt deflation is however the result of a Minsky process of sustained increasing financial fragility. However, to understand this process requires an analysis of the evolution of the US financial starting from the implementation and deterioration of Glass-Steagall New Deal legislation. An analysis of the “moment” is not sufficient for this purpose.

By the same token, regulation of the system cannot be effective if it is simply based on measures produced to remedy and reverse the conditions generated by the current “moment”. Unfortunately, the current approach to regulation seeks to do precisely this by applying to existing financial institutions and their existing business models a series of cosmetic changes. These include proposals to increase

¹ Senior Scholar, Levy Economics Institute of Bard College

² Bernanke, The Economic Outlook, Federal Reserve, 28 March 2008, Paulsen, Washington Post, 20 September, 2008.

³ “Using Minsky's Cushions of Safety to Analyze the Crisis in the U. S. Subprime Mortgage Market,” *International Journal of Political Economy* Volume 37, Number 1 / Spring 2008, pp. 3–23.

bank capital ratios, set a maximum leverage ratio and a minimum liquidity ratio, along with ex post controls on executive pay and traders bonuses. But, the basic structure of the system will remain unchanged. If this was only a Minsky “moment” its analysis cannot provide the basis for effective reregulation. Effective proposals can only emerge from analysis of the longer-term structural changes analysed from the point of view of Minsky’s financial fragility hypothesis. This presentation seeks to identify two types of structural changes in the system that reforms must seek to redress and reverse based on a Minsky process, rather than from a Minsky Moment. The first is the way the financing of business by means of structured securitization has led to an integration of banking and finance functions, and the second is the way these structures have reduced system liquidity by increasing financial layering. This analysis leads to the conclusion that in a purely privately owned financial system it is impossible to fully separate deposit-taking “commercial banks” from capital market activities if securitization is maintained as the basic form of financing. But, it is possible to prevent banks from engaging in particular types of financial activities, in particular proprietary trading and the financing of certain types of arbitrage trading. That is, there should be a distinction between those financial institutions that create credit through liquidity arbitrage and those that arbitrage credit to engage in risk arbitrage and a limitation on the ability of the former to provide credit to the latter as well as a preclusion of their ability to engage in the latter activities.

II. What do (should?) banks do?

It is a common criticism of the current policies to support the recovery of the financial system are not functioning efficiently because banks are not lending. Rather, the expansion of the Fed’s balance sheet since the Autumn of 2008 has simply expanded banks’ excess reserves. However, this criticism ignores one of the basic structural changes underlying the recent financial crisis. Banks no longer “lend” to the non-bank business section. If at all they primarily lend to themselves, i.e. to other financial institutions. The problem is the financial system is not lending to themselves.⁴

This is a major departure from the ideal operation of the financial system envisaged by the 1933 Banking Act. It was designed to produce a system in which Federal Reserve member banks offered transactions deposits to the public, backed by deposit insurance and required minimum reserves, and lent funds on a short-term basis to finance the work in progress or other types of fully collateralised business activities. Thus Section 16 of the Act defines the “business of banking” as “discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; ... receiving deposits; ... buying and selling exchange, coin, and bullion; ... loaning money on personal security; ... obtaining, issuing, and circulating notes...”⁵

⁴ This is why Richard Koo’s recent attempt (*The Holy Grail of Macroeconomics*) to use his analysis of Japan’s crisis to the current situation crisis (there is no lending because borrowers are busy paying down debt) does not apply. There are financial institutions that are deleveraging but still need to borrow to augment capital and support asset books, but there are no lenders.

⁵ Documentary history of Banking and Currency in the United States, Herman E. Krooss, editor, Chelsea house Publishers in Association with McGraw-Hill, New York, 1969, Vol. IV, p. 2755.

In addition, financial institutions in the business of banking were protected from competition from financial institutions doing other types of business. Section 21 specified that “any person, firm, corporation, association, business trust, or other similar organization, engages in the business of issuing, underwriting, selling, or distribution, at wholesale or retail, or through syndicate participations stocks, bonds, debentures, notes or other securities, to engage at the same time to any extent whatsoever in the business of receiving deposits ...” (Ibid., p. 2761).

Together the restrictions on permissible activities and protection of those activities were intended to provide support for the two basic functions of the financial system, providing a safe and secure transactions system by insuring the value of transactions deposits and ensuring that financing was available to business borrowers to support their ongoing production operations, leaving the long-term funding of their capital investments to financial institutions operating in the capital market.

Economists have generally argued that these protections created a monopoly environment for deposit taking banks, and like all other market restrictions would produce economic efficiencies in the operation of the protected banks themselves that would eventually render them subject to increasing internal and external competitive pressures from more efficient non-regulated institutions. In addition, even before Alan Greenspan’s now famous confession concerning the operation of enlightened self-interest, it was believed that these market restrictions were unnecessary to provide financial stability. Characteristic of this position is George Kaufman’s statement that “most of the individual proposals focused on increasing bank safety by decreasing competition in a particular area, ... [thus] the Act, taken as a whole, was blatantly anticompetitive. ... The commercial banking sector became progressively disadvantaged relative to other sectors that could offer similar products with fewer restrictions. ... Today, there is general agreement among economists that most, if not all, of the restrictions imposed by the Banking Act no longer are necessary, if they ever were, at least for restricting risk.”⁶

Unfortunately, this ideal view of Glass-Steagall separation deposit banks providing the short-term financing of business operations from the rest of the financial system dealing with the long-term funding of capital investment has not proven to be a stable structure for the financial system. If it ever existed, it no longer does. As everyone now recognizes, in a formal/technical sense banks no longer “lend” because they do not own the loans they originate. Instead the loans are aggregated and transformed into ersatz fixed return capital market assets that are sold to a variety of private sector final investors. It is the widows and orphans who lend and own. A formal justification of this process is that it allows for a better distribution of risk throughout the system, but it has simply resulted in a shift of the risk of short-term lending from financial institutions to the general public, many of whom do not even know they are bearing the risk.

But, this redistribution of risk has been facilitated by a misrepresentation of risks that takes two forms. First it is represented as a transformation of individual or idiosyncratic alpha risk into systemic or market beta risk through diversification and aggregation of the loans. Second, it produces a transformation of long-term, higher risk assets into short-term, lower risk assets. However, both of these transformations

⁶ George G. Kaufman, “Securities Activities of Commercial Banks: Recent Changes in the Economic and Legal Environments,” *Journal of Financial Services Research*, 1, 1988, pp. 184-5.

involve capital market operations that were forbidden to banks under Glass-Steagall. The ability to engage in this process of redistribution and reduction of risk is the source of the competition that caused protected banks to lose their traditional loan business and eventually drove them to seek a release from the New Deal monopoly protections that had been transformed from protection to ensure safety from competition and an assured return to an impediment to respond to competition from non-banks.

From this point of view the problem with Glass-Steagall was that it attempted to provide monopoly protection to ensure the stability of financial institutions, rather than the protection of the financial functions that they were supposed to provide to the non-bank business sector. The important distinction in Glass-Steagall was between the short-term financing of business activity and the long-term funding of the private business investment. Once this was broken down in the quest for increased efficiency, the former was sacrificed in favour of the latter. However, it is not clear that the process of disintermediation that eroded the protection of banks provided an improvement in efficiency in restricting risk.

III. Financial stability versus increased efficiency

The transformation of the business loan market was driven by the push by business borrowers for lower rates and the costs incurred by banks in providing business loans. This difficulty stems in part from a confusion in the traditional description of the role of banks between “deposit taking” and “deposit making.” It is basically the high technical costs of providing transactions accounts, as well as their regulation, that makes deposit taking a high cost activity which has resisted productivity increases even with the introduction of automated bank tellers and other costs reduction measures.⁷ However, the provision of transactions accounts is not directly related to the activity of financing business through loan origination. This requires “deposit making”, an activity that has been subject to productivity improvements resulting from the application of computational advances and statistical theory. As a result, even when banks were given free Regulation Q deposits under Glass-Steagall, these deposit taking costs made it difficult to compete with non-banks when the banks’ monopoly protections came under pressure.

It was asset securitization that provided the means for non-banks to challenge the monopoly protection that Glass offered to banks by producing lower financing spreads through risk reduction and redistribution. The first step in this process was the issue by corporations of commercial paper as a substitute for traditional short-term bank lending, reinforced by the growth of money market mutual funds to provide a growing demand for these assets. Then asset securitization produced further reductions in financing costs as asset backed commercial borrowing was used to issue asset backed commercial paper which could be purchased by a money market mutual fund. Through this process of financial layering firms were eventually able to obtain finance and funding in the most liquid, lowest interest rate market for both their short and long term financial requirements.

⁷ This is also in part due to the archaic means of compensated settlement for check clearing practiced in the United States banking system. On this point see Martin Mayer, *The Bankers*, New York, Truman Talley, 1998.

But banks could not compete directly in this process because all of these product innovations required capital market operations that were forbidden to them by the Glass-Steagall monopoly protections. It is thus not surprising that both regulated banks and business firms cooperated in breaking down the monopoly while, paradoxically non-bank financial institutions consistently fought the actions to dismantle the Glass monopoly protections!

While these changes have been represented as financial innovations, they were also regulatory innovations since they could not have been introduced without enabling legislation by the SEC and regulatory interpretations by the Federal Reserve that supported those who sought the erosion of the Glass protection of banks. Again, ironically in order to protect regulated banks. It was these regulatory changes that eventually eliminated the separation of banking and finance auspicated under the New Deal regulations and produced the shift from traditional net interest margin banking to financial arbitrage risk reduction. A move that has caused the shift of bank lending away from business borrowers, and toward lending to support the holding of financial assets by other financial institutions.

IV. Deregulation to save the deposit banks from their protection

The traditional Glass-Steagall approach to banking can be considered as a swap transaction in which a bank swaps its own liability, a deposit, for the short-term collateralised liability of a business firm. The bank's earnings are determined by the rate differential – a difference that is maximized by increasing the credit assessment of the borrower reducing the rate of charge offs on loans. As Minsky has pointed out, a financial institution can only earn income on this spread if the rate on the liability is lower than on the asset. This means that their liabilities should have a higher liquidity premium than that on the assets they finance. In the case of the difference between deposit liabilities and C & I business loan assets this is relatively straight forward. Deposit insurance, reserve balances and supervision ensure that the bank's deposits issued to a business firm in the form of a loan have a liquidity equal to that on currency issued by the Federal Reserve. Thus, a deposit that is a perfect substitute for currency has the highest liquidity premium and thus the lowest, risk free interest rate.

In contrast, in a securitized lending structure liquidity is created on the balance sheet of a separate institution, technically a trust or a special purpose entity or vehicle, that by the magic of diversification and aggregation "arbitrages" higher risk assets into lower risk assets. This leads to a different type of swap spread, and a process that focuses on market mispricing rather than credit assessment that increases the efficiency of the banking system.

This securitization process has been described as "riskless arbitrage":⁸ "When one looks at any class of properly structured loans as a national aggregate, they will perform in line with national economic trends. If properly underwritten to statistically significant standards, and appropriately assured against

⁸ Frederick L. Feldkamp, "Crises and Recoveries, 1987-2009: Myths, Rumors and Possible Truths," September 1, 2009, note 1.

default, variance in performance of properly pooled and valued loans will be determined by national trends in interest rates and national economic success or failure. At various times since 1987, loans underwritten and sold in financial markets have sometimes lived up to these underwriting standards and have sometimes failed them miserably. For riskless arbitrages to work appropriately, markets must produce loans worthy of reliable and predictable arbitrage. ... In loan arbitrage transactions, the price to arbitrage versus the gain created by spread determines profit or loss. The higher the "spread" the more profitable it is to pool loans and fund them in high grade bond markets (the arbitrage process), assuming the ability to freely arbitrage on a consistent basis."

But this price arbitrage involves the financial institution in assessing a very different series of issues than in traditional spread implicit in net margin lending. Instead of a spread between borrowing and lending rates determined by the ability of the bank to assess credit risk and to ensure the liquidity of its liabilities, riskless arbitrage requires just the opposite process. "A "riskless arbitrage" arises whenever a market participant can acquire a commodity at a lower price in one market than the price at which it can sell that same commodity in another market and lock in a price differential that guarantees a profit. ... In financial market "riskless arbitrages," participants: (1) originate or acquire loans at a rate on the "high" side of a rate spread and (2) "pool" them in a manner that either properly diversifies and moderates individual loan loss risk or insures against default, provides assured servicing and collection for pool investors and, ultimately, justifies a superior rating for securities backed by the pool. The arbitrageur then sells securities priced at the "low" side of a rate spread in amounts that lock in a differential which guarantees profit." Here it is the diversification and structuring of the securitization that produced risk reduction along with the distribution of the assets into the overall market that increases liquidity for the securitized product and converts high rate, more risky, assets into lower rate, less risky, assets. The process has nothing to do with the qualities of the borrower or the ability of the bank in assessing them. And the income that is generated comes not so much from the interest spread or margin as the addition of the fees and commissions that result from the loan originations and the underwriting of the securities.

Since this process of price arbitrage involves the creation of affiliate structures, underwriting and other capital market activities that regulated banks could not undertake while subject to Glass they were forced to seek exemptions from their monopoly protections. This required the creation of entities that could engage in such capital market and other underwriting activities. And this is precisely what banks sought to do, aided by the 1987 interpretation by the Federal Reserve of Section 20 of Glass Steagall to allow banks to affiliate with entities dealing in securities.

The legislators who wrote the New Deal legislation were convinced that the collapse of the system had been caused by the creation of state chartered affiliates by national banking associates which allowed them to operate in capital market activities that were forbidden to them under Federal legislation. The Section thus forbids banks from being "affiliated in any manner ... with any corporation, association, business trust, or other or similar organization engaged principally in the issue, floatation, underwriting public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes or other securities, (Ibid, p. 2760) while Section 21 forbid such or similar organizations from taking deposits. The intention was to separate the deposits of the public from

exposure to any capital market activities. However, Section 13 which states that “No member bank shall (1) make any loan or any extension of credit to, or purchase securities under repurchase agreement from, any of its affiliates, or (2) invest any of its funds in the capital stock, bonds, debentures, or other such obligations of any such affiliate, or (3) accept the capital stock, bonds, debentures, or other such obligations of any such affiliate as collateral security for advances made to any person, partnership, associate, or corporation, if, in the case of any such affiliate, the aggregate amount of these loans, extensions of credit, repurchase agreements, investments, and advances against such collateral security will exceed 10 per centum of the capital stock and surplus of such member bank, or if, in the case of all such affiliates, the aggregate amount of such loans, extensions of credits, repurchase agreements, investments and advances against such collateral security will exceed 20 per centum of the capital stock and surplus of such member bank”. (Ibid. pp. 2752-3) with an over collateralization of 20 per cent on the value of all such operations.

However, in 1985 the Fed ruled that bank holding companies could acquire as subsidiaries firm that offered both brokerage and investment advice to institutional customers. In April 1987 an interpretation of Section 20 issued with the express intention of allowing regulated banks to engage in securitization gave approval to member banks to engage in affiliation with companies underwriting commercial paper, municipal revenue bonds, and securities backed by mortgages and consumer debts, as long as the affiliate did not principally engage in those activities. The decision interpreted “principally engaged” as activities contributing more than 5 (subsequently raised to 10 per cent) of gross revenues. Both rulings subject to legal appeal by investment banks seeking now to protect themselves from encroachment from regulated banks, but both were approved by the relevant legal jurisdictions.

These interpretations had two important implications. The first was that it allowed banks the ability to engage in securitization⁹ and the second was that in order to absorb their additional affiliate earnings they needed to expand the gross income of the affiliates, which they did by expanding their repurchase business. Thus, the decision by the Fed to allow banks to enter securitization also produced the expansion of banks into short-term collateralized lending through repurchase agreements.

V. How the Regulators Aided and Abetted the Decline of Banks

But, additional legislation was required in order to allow the transformation of traditional bank lending into securitized lending. There were two steps involved. Since the process involved capital market activities, they involved SEC decisions on the activities of non-bank institutions than the interpretations of the Fed. A securitization involves the creation of an independent legal structure, usually called a special purpose vehicle or entity. This creates a conundrum for securities legislation. If its liabilities are securities that are subject to regulation by the SEC, then the entity that issues them should also be subject to SEC regulation since it is formally an investment company under the 1940 Investment Company Act.

⁹ An issue that Minsky considered crucial but, did not discuss in great length in his published work, see “Securitization,” The Levy Economics Institute of Bard College, Policy Note, 2008 /2, with Preface and Afterword by L. Randall Wray.

The definition of an investment company under the Act would subject most structured financing securitization arrangements to SEC regulation because they issue securities to the public (typically in the form of bonds or equity interests), and invest in, own, hold or trade securities. These regulations would have largely offset the profitable spread operation of the “riskless arbitrage” noted above had it not been for an exemption granted in Rule 3a-7 in 1992 for Issuers of Asset-Backed Securities that excluded virtually all structured financing arrangements from the definition of an investment company.¹⁰ At the same time the SEC provided for shelf-registration for such structures, opening the way for full development of the implementation of riskless arbitrage. This was simply a parallel of the allowance that had been granted to investment banks for equity underwriting. While these structures were first experimented in mortgage lending, they soon spread to all types of private assets, eventually allowing banks to use their loans as collateral for securitized structures. This opened another way for banks to organize and operate affiliates, but in difference from Section 20 relations, these were not regulated.

Money market mutually funds first appeared in 1971 and were considered short-term investment pools that were subject to registration requirements under the 1940 Investment Company Act, and in 1983 were regulated under SEC Regulation 2a-7 to ensure that the underlying net asset value of a MMMF’s assets would support their advertised \$1 per share. Defaults by commercial paper issuer in 1989 and 1990 led to additional restrictions on risk limitations on credit quality, diversification and maturity for such structures. It also set limits on concentration, requiring 95 per cent of assets be invested in first tier Treasury securities, and no more than 1 per cent of its remaining 5 percent Second Tier assets in any one issuer. They originally invested in short-term government paper and commercial paper, and represented a major competitor for both bank depositors and bank borrowers. In 1982 Congress authorized such accounts for regulated banks in the form of money market deposit accounts.

In 1983 commercial paper outstanding accounted for about a fifth of the 1 trillion in non-mortgage loans on the books of banks and finance companies. By mid-2007 it over half of the 3 and a half trillion of on balance sheet assets. Money market mutual fund holdings of commercial paper was a third of the total.¹¹ Federal and state regulators also helped to expand the acceptance of money market funds among institutional investors. For example, money market funds have been approved as investments for national banks by the Office of the Comptroller of the Currency; for state-chartered banks by the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation; and for federal credit unions by the National Credit Union Administration. They have been approved as an investment vehicle for customer funds held in custody by futures commission merchants and futures clearing organizations by the Commodity Futures Trading Commission and for margin collateral by the Clearing Corporation, the New York Mercantile Exchange, the Chicago Mercantile Exchange, and the Options Clearing Corporation. State and municipal entities also hold money market funds. In addition, the SEC has approved investment of the prefunded portion of an asset-backed issuance in money

¹⁰ See V. Siclari, “A tough act to follow: How to deal with the Investment Company Act of 1940,” <https://www.abanet.org/buslaw/blt/bltjan01siclari.html>

¹¹ Report of the Money Market Working Group Submitted to the Board of Governors of the Investment Company Institute, Washington, D.C., March 17, 2009, p. 20.

market funds. Revisions of the regulation in 1992 allowed repurchase agreements to be considered as equivalent to investments in the underlying securities as long as they were fully collateralized and revisions in 1997 dealt with their investment in asset backed securities as long as they received appropriate ratings from a NRSRO, however, there was no requirement “whether the rating received must be short- or long term.” (Ibid. p. 162) With the introduction of structured finance, money market funds also expanded their acquisition of asset backed securities issued as the liability of unregistered securitized structures. It thus became possible to finance long-term corporate debt to the public by means of a money market fund that offered liquidity that was equivalent to that of a regulated bank deposit but with a higher interest rate.

The general impact of the combination of money market funds and structured securitization is to convert less liquid, higher risk securities into more liquid, lower risk securities. The benefits that accrued to business borrowers in the form of lower financing costs were only possible by the creation of additional liquidity for the liabilities of the entities. The impact was to challenge the ability of banks to function by making their liabilities more liquid than assets, and to increase system liquidity without the same hedging measures imposed on banks to ensure the liquidity and price of deposit liabilities. It is exemplary of the US regulatory system that money market deposit accounts and regulated bank deposits are considered equivalent, yet the issue of the former is regulated by the SEC while the latter is regulated by the FED, the OCC.

The systemic increase in liquidity was further enhanced by the already referenced interpretation of Section 20 allowing affiliation with entities not principally engaged in capital market activities. Section 16 of the Banking Act had made it clear that the purchase of “any shares of stock of any corporation” was forbidden. Further, “the business of dealing in investment securities by the association shall be limited to purchasing and selling such securities without recourse, solely upon the order, and for the account of customers, and in no case for its own account, and the association shall not underwrite any issue of securities (p. 2755).

However, the Supreme Court had broadly interpreted the Section 16 ability “To exercise . . . all such incidental powers as shall be necessary to carry on the business of banking” in a broad fashion so as to include dealing in securities. A Federal Reserve interpretation of the Bank Holding Company Act Section 4(c)8 extended these similar powers to Bank Holding Companies and their affiliates. Thus many activities that are not included in the powers listed in Section 16, including equity derivative transactions and risk management activities such as derivatives and equity trading to hedge risks arising from banking activities, also came to be considered as a part of the business of banking. This eventually led to the basis for the creation of proprietary trading by banks, as well as dealing in derivatives.

However, there was another aspect of the Section 20 exemption that was even more important. The limitation on earnings from capital market activities was set as a share of the gross earnings of the affiliate. This meant that it had to generate 95 per cent of its income from permitted activities. Since banks were granted the ability to deal in government securities, the affiliates expanded their activities in this area, generating revenues through matched book repurchase activities. This laid the basis for the growth of the entire repurchase or “repo” market. This had two impacts. First, it provided an alternative

investment for corporate short-term deposits, since Treasury bill rates could be earned on overnight money. On the other hand, it provided the possibility for spread traders to finance their positions by funding their through the repo market. These activities eventually led to an unregulated over-the-counter market that was responsible for funding trading books with corporate money, a market that was as important in the current crisis as the credit default market.¹²

Over the counter derivatives also provided a means of defence for the banks as they offered a way to increase the rates they could pay for deposits after Regulation Q limits were removed. This was achieved by packaging an option contract with the traditional deposit account. An example is the "market index investment account," composed of a fixed-term deposit with a return that is linked to the performance of the equity market via an index such as the S&P 500 stock index. Depositors were offered maturities of three, six and 12 months combined with three combinations of minimum guaranteed return plus a percentage share of the change in the equity index. Since it is a deposit, it is subject to FDIC insurance. These accounts differ in only two significant ways from a stock mutual fund invested in the relevant index. First, they have a fixed maturity or redemption date (although early redemptions may be permitted with penalty of loss of all interest and part of the principal) and they have a guaranteed minimum value. Banks would have to hedge these instruments by buying the index future in the appropriate proportion, an activity permitted because cash settled futures are not considered securities. (See Kaufmann, pp. 191-2)

Thus there are three major areas which have had a direct impact on financial fragility and emerge from the paradox of monopoly protection reducing instead of ensuring profitability and stability in support of transactions deposits:

Asset securitization – including money market funds

Section 20 affiliates: Proprietary trading and the over-the counter repo market

Derivatives trading

All have: diminished the ability of banks to compete in offering their core activity of providing financing to business.

All of them require capital market operations that were originally precluded by monopoly protection granted by Glass to ensure incomes sufficient to protect transactions deposits.

All of them were granted regulatory support which allowed them to develop.

All of them create market liquidity through the financial structure, rather than through the ability of banks to issue liabilities that are a substitute for currency.

As recently confirmed by the Chairman of the SEC, "asset-backed securitization is a financing technique in which financial assets, in many cases themselves less liquid, are pooled and converted into

¹² On the original development of this practice of writing matched book repos, as well as the various frauds due to lack of regulation, see Stigum, M. 1978. *The Money Market: Myth, Reality, and Practice*, Revised ed. Homewood, Ill.: Dow Jones-Irwin, 1983. On the role in the current crisis see Gorton, Gary B., "Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007" (May 9, 2009). Available at SSRN: <http://ssrn.com/abstract=1401882>. The early market drew Minsky's attention "Central Banking and Money Market Changes." *Quarterly Journal of Economics* 71 No. 2 (May), 1957.

instruments that may be offered and sold in the capital markets.”¹³ The combination of the of the exemptions given to money market mutual funds and securitized special purpose entities has thus allowed the system to convert long-term illiquid assets into the short-term equivalent of bank deposits or into capital market assets that depend on financial institutions acting as dealers to provide liquidity.

VI. Regulatory Changes?

The first point is that there really is no going back to Glass-Steagall separation of banking and finance and the traditional ideal of bank financing of short-term business financing short of abolishing securitization.

The second is that part of the problem was created by the confusion between “deposit taking” and “deposit making”. It is impossible to allow prudentially regulated and a market regulated institutions to coexist. Government provides currency, it should also provide transactions accounts. Banks originally got into this business because they could profit from it. They clearly no long can.

The third is to recognize that difference between liquidity created by bank net margin spreads and created by risk arbitrage. The latter needs to be controlled in the same way as the former. Chairman Schapiro has already called for comprehensive regulation of securitization. It is also important to recognize the different income incentives between net interest margin banking and risk arbitrage banking. While it is impossible to go back to the traditional model, this should not be conceived as attempting to restore separation, but rather an attempt to create income incentives that induce a return to credit evaluation as the business of banking.

Fourth, banks who do remain as deposit taker should not be allowed to engage in proprietary trading.

Fifth, the exemption that excludes hedge funds from registration as investment companies or investment advisers should be ended. However, they should not be further regulated.

Sixth, there is a confusion between big banks (too big to fail) and financial supermarkets. It seems clear that there are few synergies in joining different financial functions in a single institutions. Institutions can be large, so they can compete globally, but they should be focused. It is financial markets that need to be large to provide funding for large corporations. Large banks should be broken up an organized around related functions. Hedge funds seem to function at small size and now provide many of the functions of larger banks with greater stability. It is interesting that most all analysts accept that hedge funds contributed little to the current crisis, while it was the most highly regulated part of the market that were the source of the problem.

Finally, the SEC exemptions on financial contracts, such as private placement, derivatives, etc, should be eliminated. They need not be regulated as to form, but they must be regulated and the markets in which they trade should conform to other exchanges.

¹³ Speech by SEC Chairman Mary Schapiro, "The Road to Investor Confidence", SIFMA Annual Conference, New York, New York, October 27, 2009 that noted the need for comprehensive Congressional legislation for these structures.