Investment Banks and the US Deregulation Process

(Preliminary draft)

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Abstract:

The purpose of this paper is to analyze the roll of deregulation process in the expansion activities of investment banks in the Unites States. We will examine the gradual shift away from the Glass-Steagall Act and the introduction of the Financial Modernization Act. We will demonstrate that this deregulation process encouraged Investment banks to engage in practice and operation that created significant systemic risk. Securitization activity, in which investment banks engaged, was a result of the financial deregulation process that transformed US financial structure from being bank-based to being market-based. We will argue that this new financial structure requires the implementation of a specific regulatory regime for products and financial institutions in order to reduce the possibility of another financial crisis.

For the last three years, since the subprime financial crisis began in 2007, banks and other financial institutions around the world have reported $1.1 trillion of losses. Seventeen large universal banks account for more than half of those losses, and nine of them either failed, were nationalized or were placed on government support[1]. Governments like U.S. and UK have provided great sums of money to support financial institutions to prevent the collapse of global financial markets.

According to Wilmarth (2009), " the losses suffered by universal banks [through their investment banking department] demonstrate that they are clearly the epicenter of the global financial crisis. They [investment banks] were also the main private sector catalysts for the credit boom that precipitated the crisis".

[1] Arthur Wilmarth mentions that U.S. and UK governments have provided $9 trillion of support to financial institutions given the massive losses suffered by universal banks.

In the last three decades, finance has been transformed worldwide by deregulation process, globalization, and financial innovation. These trends have altered the way US financial system operates today. During the New Deal age, US financial system was centered on strictly regulated commercial banks that were organized nationally (Guttmann, 1997, 2008, 2003). Now in the 2000's, this system is self-regulated, global, and centered on investment banking. The preference for financial markets over using commercial banks has been facilitated by the emergence of funds such as: pension funds, mutual funds, hedge funds and equity funds as main buyers in those markets. Important financial innovations and deregulations made over the credit system, have promoted more flexible finance to meet the needs of both creditors and debtors. However, these innovations also promote asset bubbles, underestimation of risks, and excessive leverage that put in to risk the worldwide interconnected financial system.

I. Deregulation Process in the U.S.

In the midst of the persistent banking crisis during the Great Depression, the Roosevelt administration introduced important financial reforms. It quickly passed the Banking Act of 1933 (popularly known as the "Glass-Steagall Act"), which instituted several important financial reforms such as the introduction of Federal Deposit Insurance and the implementation of the Glass-Steagall Act . This Act reshaped the financial landscape by separating commercial from investment banking. The Glass-Steagall Act specifically prohibited the involvement of commercial banks in security underwriting and its participation in speculative markets to prevent abuses which could result from such activities. According to Kregel (2010)…"The purpose of the Act was to reverse a loose banking policy which had turned from the making of loans on commercial paper to the making of loans on security."

The post-war regulatory regime for banking was characterized as a system of nationally administered credit-money based on low interest rates, fixed exchange rates, tight regulation of banking activities, and bank loans known as Bretton Woods system. The Bretton Woods system fell apart in a series of speculative attacks against an overvalued dollar. Those attacks were promoted by Eurocurrency market; the major financial innovation emerged during the early 1960s that put excess dollars into international circulation. The Eurocurrency market made it easy to move funds in and out of countries and currencies as a medium for currency speculation. It also enabled banks and their clients to evade many domestic regulations like America's controls on capital outflows and interest-rate ceilings. In the 1960s, US banks introduced a series of new market instruments (federal funds, commercial paper, negotiable certificates of deposit, bankers' acceptances) to expand credit outside the controlled deposits through Eurodollar deposits. Eurodollar markets helped US banks to escape the Fed's interest-rate ceilings on domestic deposits or controls on capital outflows (Guttmann, 2009). According to Guttmann (2008), "U.S. banks had to face the new world of deregulated money prices, the strategy was investing heavily in foreign-exchange trading and compete for funds with higher deposit rates. Banks resume price competition for the first time since the Great Depression during late 1970s, they sought to compensate for costlier funds by seeking higher-yielding assets and pushing into fee-generating activities that would leave them less exposed to interest-rate risk and less dependent on interest income. They were greatly helped in this diversification push by ambiguities resulting from a rather chaotic regulatory structure in the United States."

In the 1980s, Reagan (and Thatcher) pushed the free-market doctrine across the world promoting privatization and deregulation as a policy for the "proper operation" of international economics. Deregulation of banking spread from the United States to Europe and to many developing countries. This practice was strongly promoted by the International Monetary Fund that pushed liberalization of capital movements worldwide during the 1980s and early 1990s.

Inside of United States, federal regulators started to oppose the Glass-Steagall Act in response to growing competitive pressures in the financial marketplace. According to Willmarth 2009, in 1987 and 1989, the Federal Reserve Board allowed bank holding companies to underwrite debt and equity securities to a limited extent. This process continued during the 1990s, at the point where subsidiaries could compete effectively with securities. As an example, in 1998, the Federal Reserve Board allowed Citicorp, the largest U.S. bank holding company, to merge with Travelers, a major financial conglomerate that owned a leading securities firm, Salomon Smith Barney, as well as subsidiaries engaged in insurance activities. That merger produced Citigroup, the first U.S. universal bank. In this sense, long-standing barriers to the geographic reach and range of permissible activities were gradually removed with the establishment of the Financial Services Modernization Act, which repealed the restrictions of the Glass-Steagall Act for the American financial-services industry.

Deregulation has enabled banks to expand into new geographic areas as well as widen the range of their services. While there remained many specialized niche players across the entire financial sector, the world's leading financial institutions have all become huge conglomerates integrating different types of services, instruments, and markets. Typically they combine several financial functions (commercial banking, investment banking, fund management, private wealth management, and insurance) under one organization. These financial groups and their trans-national organization are what make finance globally interrelated with a high degree of concentration in the provision of banking services.

Nowadays, the erosion of the regulatory framework coincided with an era of increased financial innovation and instability, all this promoted by the repeal of Glass-Steagall. The subsequent domestic financial tumult reflected, in part, the combination of commercial and investment banking. Some scholars, (D'Arista, Guttmann, Rusell), have argued that the entry of commercial banks into investment banking contributed to the financial disarray of the 2000s. One recurrent theme of this critique is that the merging of commercial and investment banking created

conflicts of interest that influence the commercial bank's lending activities in ways that affects financial system stability. According to Russell (2008), "…commercial banks may be less vigilant about the quality of its loans if it believes that it can use the investment bank's underwriting capabilities to relieve it of problem borrowers. The investment banking arm might enable problem borrowers to issue securities and thereby repay their loans (for example might include the possibility that the commercial bank dilutes its lending standards for –say home mortgages – insofar as it intends to pass these loans on to investment banks to be securitized). The commercial banking arm of a financial conglomerate may also be forced to use its lending portfolio to advance the agenda of the investment banking arm. Loans may be advanced to finance the purchase securities (possibly with the securities themselves acting as collateral). Investment banks may be better situated to attract underwriting business if they can lend funds to firms in the period prior to the issuance of securities. It is also possible (but illegal) for a diversified financial capitalist firm to engage in "loan-tying" (making the availability of credit conditional on other business interactions). Loans might be made to the investment banking arm itself (or, if this is prohibited, less overt means of accomplishing the same thing may be devised) to finance the carrying of inventories of securities or to enable the investment bank to trade "on its own account" (to trade securities in pursuit of capital gains).

In general, commercial banks and investment banks struggled to subvert the Glass-Steagall regulatory categories. Investment banks sought to perform traditional banking activity through financial innovations that competed with commercial banking system and intermediate funds to fund other activities outside of traditional banking channels in a development of a parallel banking system. On the other hand, commercial banks responded to this competitive pressure by pursuing financial innovations intended to enhance their profitability in both their traditional activities and new lines of business. Commercial banks also evaded prudential regulation that disadvantaged them against investment competitors (for example, banks succeeded in having required reserves reduced), all this competition among banks had a strong repercussion in the

financial system stability due to a variety of risks financial institution incurred as a result of the Glass-Steagall Act removal. In November 1999, Congress passed the Gramm-Leach-Bliley Act, which authorized the creation of holding companies like Citigroup, and approved universal banking. The Gramm-Leach-Bliley Act also allowed commercial banks to affiliate with securities firms and insurance companies within a financial holding company structure. The Gramm-Leach-Bliley supporters argued that financial holding companies would produce significant benefits for the U.S. financial services industry and the broader economy. The predicted benefits included enabling financial holding companies to earn higher profits based on favorable economies of scale and scope, allowing financial holding companies to achieve greater safety by diversifying their activities, permitting financial holding companies to offer “one-stop shopping” for financial services, resulting lower costs for businesses and consumers, and enhancing the ability of US financial institutions to compete with foreign universal banks. In contrast, opponents of this Act argued that the new universal banks were likely to generate financial risks and speculative excesses. The removal of Glass-Steagall’s constraints might ultimately cause a financial crisis similar in magnitude to the Great Depression (Wilmarth, 2009).

II. Interconnections among the larger financial institutions

During the last two decades, governmental policies in the U.S. encouraged consolidation and conglomeration within the financial services industry. As mentioned before, the Gramm-Leach-Bliley Act of 1999 was an example of a deregulation trend in favor of universal banking. Domestic and international mergers among commercial and investment banks produced complex mega banks that dominate domestic and global markets. More than 5,400 mergers took place in the U.S. banking industry from 1990 to 2005, involving more than $5.0 trillion in banking assets. The share of U.S. banking assets held by the ten largest banks raised from twenty- five percent in 1990 to fifty-five percent in 2005. The three largest U.S. banks Citigroup, Bank of America, and JP Morgan Chase held more than $1.5 trillion of assets at the end of

2007. Investment banks also acquired dozens of U.S. securities firms. For example, Chase acquired numerous small investment banks and later on merged with J.P. Morgan (a commercial bank). Large securities firms made their own acquisitions too. For instance, Smith Barney acquired Shearson in 1993 and Salomon both of them became part of Citigroup when Travelers merged with Citicorp in 1998 (Wilmarth, 2009). Through deregulation and consolidation commercial banks and investment banks pursued a dominan positions in the capital markets.

As the financial industry has consolidated in the US, investment banks and commercial banks firms have grown significantly in size and expanded their global reach. They are now often referred to as integrated investment banks, financial services conglomerates or global investment banks and represent concentrations of vast economic power and political (Tuch, 2006, Morrison, 2007), offering multiple products and services to a substantial number of clients in major financial centers worldwide. This vast concentration of economic power is derived from their ability to raise capital from outside sources as well as their advisory activities on Mergers and acquisitions and proprietary trading. This represents a problem, because it creates conflicts of interest as it puts institutional traders in competition with their customers.

The systemic risk was directly related to the Interconnections among the larger financial institutions. This interconnections were the result of the cross operation of borrowing and lending between banks to fund proprietary trading in the long term (D'Arista, 2009b). These transactions were not traded for bank's costumers' accounts, but by their own account. As the borrowing to one another among financial institution, the system became descapitalized to the point to a general insolvency contributing in this way to the system's vulnerability.

Mega banks use financial instrument to maximize their fee income and reduce their capital charge as well. Financial innovation helps to transfer the risks associated with securitized loans.

Securitization enabled mega banks to extend huge volumes of home mortgages and credit card loans to nonprime borrower and regulators did not seriously consider whether financial conglomerates threatened the stability of the financial markets. They simply assumed market discipline would exercise sufficient control over the growing power of mega conglomerates.

III. Financial Innovation and Securitization Process

Securitization has been the most important financial innovation that occurred in the 1990s. This important innovation process transformed the US financial structure from being bank-based to being market-based and a system dominated by finance (D'Arista, 2010, Guttmann, 2009). The term financial innovation refers to the development of financial products designed to achieve particular client objectives to assist with obtaining financing. For instance: the adjustable-rate mortgage; the bundling of subprime mortgages into mortgage-backed securities (MBS) or collateralized debt obligations (CDO) for sale to investors, a type of securitization; and a form of credit insurance called credit default swaps (CDS). These products are complex and difficult to regulate and assess. An example of this is the off-balance sheet financing that affects the leverage or capital cushion reported by major banks. Through this off-balance activity, banks elude regulation in the search for a bigger profit. For authorities and rating agencies, it has been difficult to calculate the operational risks having to rely on the information provided by the banks. Another important aspect of financial innovation is the creation of new networks of financial intermediation. These networks have transformed the credit system beyond the limits of traditional commercial banking.

It is in this sense, Kregel (1996) affirms that: "that the US financial system has become more market oriented: not because of increased "direct" financing. The major changes in the banking system have been in banks that have specialized in areas in which the use of such products can reduce hedging costs relative to funding margins and thereby increase revenues". All this derived, in part, from changes in regulations.

The term securitization also refers to the process of disintermediation in the banking sector where companies prefer securities markets to raise capital at more competitive rates in preference to traditional banks loan. Banks no longer provide financing to the real productive sector of the economy as necessary due to their profits that are higher in capital market and trading activities than in the loan market. Banks and other financial institutions packaged various types of loans (including mortgages) into securities and sold them to global investors.

The securitization process enables the transformation of illiquid assets into liquid assets (marketable securities) which are sold in the securities markets. Through this process banks can liquidate assets that cannot be traded until maturity (Ward, 2003). There is a great variety of assets that can be securitized, it includes residential and commercial mortgages, personal and corporate loans, and debt obligation etc. Securitization distributes risk by pooling assets and selling them to a special purpose entity, then issuing new securities backed by the assets and their cash flows. The securities are sold to investors who share the risk and reward from those assets.

According to Henry Liu, the securities market is supported by the shadow banking system and structured investment vehicle, both of them important financial innovation. The shadow banking system consists of non-depository banks and other financial entities like investment banks and hedge funds. Disruption in the shadow banking system is a key component of the subprime mortgage crisis. A structured investment vehicle was an operating finance company established to earn a spread between its assets and liabilities like a traditional bank. The strategy of structured investment vehicles was to borrow money by issuing short-term securities, such as commercial paper and medium term notes and public bonds at low interest rates and then lend that money by buying longer term securities at higher interest rates, with the difference in rates going to investors as profit.

IV. Investment Bank and Leverage

From 2004 to 2007, the top U.S. investment banks significantly increased their financial leverage, which increased their vulnerability and eventually leaded to their bankruptcy. The level of leverage was intensified by deregulation. In particular, the Financial Services Modernization Act, that permitted banks to borrow in order to fund traditional and no traditional financial investment. The Security and Exchange Commission also relaxed the leverage limits for investment banks in 2004 (D'Arista, 2009). Higher leverage ratios made it possible for institutions to borrow much more without adding more capital to back risky positions. Furthermore, leverage allowed investment banks to make substantial profits on investment with relatively low capital margins.

V. Reforming the International Financial System

In general terms, financial institutions have become too big and too interconnected with other large financial institutions to be allowed to fail; they employ excessive leverage; use too much short-term debt to finance longer term assets; and engage in risky and sometimes corrupt proprietary trading. A number of expert (D' Arista, 2010; Omarova, 2009; Guttmann, 2009, 2010; Kregel, 2010) have formulated some proposal to reform the International Financial system. We summarize these proposals that include: higher capital ratios, end "Too Big to Fail", this requires to reduce the banks' size, complexity, interdependence, and scope. Implement a new version of Glass-Steagall legislation. From the perspective of investment banks, this would mean they and their affiliates cannot engage in commercial banking activities such as accepting deposits, and have to limit their profits from commercial banking activities such as making commercial loans. Reduce leverage to safer levels. Re-instate appropriate "net capital" rules for assessing minimum capital requirements for all broker dealers. In addition, regulations should extend these rules to all investment banks at the holding/financial holding company level. Place a progressive tax on investment banks as they get bigger; the larger the bank in terms of assets

or liabilities, the higher the rate of tax. Reduce dependence on short-term borrowing. Regulatory rules must include all borrowing and financing transactions on investment banks' balance sheets, including short term borrowing and repos, and these should be properly accounted for in making leverage assessments of banks. Place higher capital requirements on assets investment banks buy through proprietary trading. Require margin requirements on all tradable instruments. Impose a tax on securities transactions to provide a disincentive for excessive trading. Reduce leverage inherent in dangerous financial products. Limit excessive leverage and increase supervision of the shadow financial system.

Conclusion

Current regulatory policies which rely on market discipline and some internal risk models are totally inadequate to control mega financial institutions tendency toward destructive conflicts of interest and excessive risk-taking. Investment banks receive enormous subsidies from their status as "too big to fail" placing them I the center of current financial crisis. Regulation of financial institutions and financial markets must be urgently reformed in order to eliminate (or at least reduce) the effects and resurgence of another financial crisis

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