Narrower Banking?

One had lost hopes that there is political will in the Anglo Saxon economies to make any significant change in the banking model which, as the 2007-08 crisis manifested, suffers from two major weaknesses:

⇒ The “too big to fail” syndrome (almost 150 banks in the U.S. have been closed down, but all the big ones rescued); and

⇒ “private profits, public losses”. The shareholders, management and traders make money so long as the going is good and, when they turn sour, the costs are borne by the taxpayer.

Two announcements by the U.S. President in the last couple of weeks make one a little less pessimistic about genuine reform. Some time back, his chief of staff had said that “you never want a serious crisis to go to waste … it is an opportunity to do things… you could not do before”. His boss seems to have taken his advice, perhaps bolstered by public anger at the huge bonuses being distributed by the major banks (Obama himself has described them as “obscene”), even as the end of the crisis and the beginning of economic recovery has, so far at least, not resulted in job creation. Unemployment remains in double digits.

The first proposal of the President is to recover from the banking industry the cost incurred by the fisc in the rescue. (The G20 Summit had asked the IMF to come out with proposals to recover the cost, which it is still to do, but Obama is not waiting.) The direct cost is estimated at about $ 120 bn, or less than 1% of GDP, much of it incurred in rescuing GM and Chrysler, the car companies, and AIG, the insurer (most banks have repaid the money taken): to be sure, this estimate ignores the huge indirect cost reflected in the sharp growth in the assets of the Federal Reserve, some of them of doubtful quality; the support given by FDIC to banks and by the government to Fannie Mae and Freddie Mac; and the much bigger cost of the recession through lost output and jobs. It is worth recalling that the Japanese banking rescue of the 1990s cost as much as 14% of GDP.

The proposal is to recover the rescue cost over a 10-year period through the imposition of a Financial Crisis Responsibility Fee (FCRF) on large banks and financial institutions. The proposed fee is 0.15% of the entity’s external liabilities in excess of $ 50 bn, less insured deposits. This fee is expected to recover the cost of the rescue over a 10-year period from about 35 U.S. institutions and 15 subsidiaries of foreign entities, as per current balance sheet sizes.

The second proposal, apart from limiting non-deposit funding of banks, would bar deposit taking institutions from engaging in proprietary trading, unrelated to servicing customers. In other words, the ban on proprietary trading, even if enacted by Congress, would leave banks free to undertake “market making” for quoting prices to customers. Banks will also be barred from sponsoring or owning hedge funds and private equity firms. Banks’ share prices dropped about 5% in response to the proposal. The proposal seems to follow Paul Volcker’s model of “narrow banking”, which envisages all customer related activities to be within its parameters. (Mervyn King’s proposal for narrow banking is more restrictive, but the U.K. government has rejected the idea summarily.)

When, some time back, Goldman Sachs had claimed that the sharp increase in its trading profit was not because of proprietary trading, but market making, I had commented that the dividing line between the two is very thin. (At that time, I had also argued that the claim was hollow in that the value at risk measure had gone up sharply, evidencing increased speculative positions.) While the western press had taken at face value the explanation for increased profits, it seems to have since caught on to the very thin dividing line between market making and proprietary trading as comments on the recent proposal evidence: both require open positions to be taken. (Incidentally, taking positions based on expected, or actual, customer orders is referred to as “front running” in the equity market and is generally frowned upon.)

But the Goldman Sachs Chairman seems to have got away with an even more blatant misuse of the word market making in his testimony before Congress last month. When questioned how his bank justified, on the one hand, selling mortgage backed securities to clients as safe investments even as, on the other, it was shorting the underlying assets, Lloyd Blankfein got away with claiming that his bank has always done market making, that is simultaneously selling and buying the same underlying asset. Neither the Congressional Committee, nor the media, caught on to the egregious error in the statement: Goldman was not quoting two way prices but was clearly only one side of the market, namely selling. Did Mr. Blankfein understand? One wonders because, had he understood, he would not have dared to utter a falsehood while giving testimony under oath.

A.V.Rajwade
Email: avrajwade@gmail.com