Investment Banking Regulation After Bear Stearns

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It is now approaching six months since Bear Stearns collapsed and regulators orchestrated a merger by J.P. Morgan that included a $30 billion subsidized loan from the Federal Reserve. The Federal Reserve has, of course, made no promises that it will bail out other investment banks that get into trouble, but there is a widespread perception that it will. Treasury Secretary Paulson, for example, recently stated (July 31, 2008): "…Americans have come to expect the Federal Reserve to step in to avert events that pose unacceptable systemic risk." The good news is that the markets will take this implicit guarantee seriously, particularly after the recent government guarantees offered in the course of taking over Fannie Mae and Freddie Mac, but that is also the bad news. If investment banks believe they will be bailed out by the Fed, and if investment bankers do not believe that big losses will cost them their jobs, then they will have incentive to gamble with the taxpayers' money. In other words, future crises are to be expected, absent a regulatory solution.

We have no doubt that the Fed will be better prepared to deal with the next crisis, but remarkably neither the Fed, nor the Treasury, nor the SEC has offered any proposals to re-regulate the investment banks so as to minimize the likelihood of a future crisis. To fill this gap, we propose a regulatory mechanism modeled on the banking regulations that already protect our payment system. Our system will (i) minimize the need for a Fed bailout in a future investment bank crisis, (ii) effectively maximize the role of market discipline in controlling investment bank risk management, and (iii) maintain the overall efficiency of the US capital markets. First, we must be clear on the conditions that led to the Fed's bailout of Bear Stearns, since an accurate understanding of these conditions is essential to creating a new regulatory framework that would render future interventions highly unlikely.

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WHY THE FED HAD TO BAILOUT BEAR STEARNS

An investment bank's activities can be divided into (among other parts) two key activities: (1) managing an investment portfolio including stocks, bonds and other instruments, and (2) operating as a central market maker and

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counterparty in the over-the-counter (OTC) derivatives market. Investment risks, if they become excessive, should be a concern for a bank's lenders and shareholders, but they do not pose a direct risk to the financial system unless investment losses prevent a bank from fulfilling its counterparty obligations in the derivatives market. Bear Stearns was rescued because it was "too interconnected to fail" due to its web of derivative contracts with the rest of the global financial system. These derivatives allow firms to speculate on or to hedge price risks arising from virtually all financial phenomenon, especially from foreign exchange rate movements, interest rate fluctuations, and credit default events. They are mainly traded over-the-counter with an investment bank as the counterparty and are individually negotiated to be tailor-made in terms of principal amounts, maturity, payoff events, and other technical features (such as the strike price when the contract is an option). As a result of this large and sophisticated market, financial firms (including banks and hedge funds) have created a complex network of interlinking derivative positions—for example, hedge fund A enters into a swap with hedge fund B because it knows B has hedged certain risks with investment bank C. This network creates systemic risk as an externality, since if one key counterparty were to fail on its derivative obligations, the failure would likely create a cascade of failures larger than any single counterparty has the incentive to try to prevent.

The dollar amounts at issue are enormous. The Bank for International Settlements estimates close to $600 trillion (that's right, trillion) in notional value of derivatives were outstanding at year-end 2007. To be sure, the notional value far exceeds the net economic value, in the same way that a prepaid one-year homeowner's policy on a $500,000 home (the notional amount) might have a market value of $1,500. Nevertheless, the net amounts and the number of contracts are still enormous, and should one dealer fail, counterparties would refuse to do business with each other because each could not understand whether the others were solvent. The financial system would freeze up long before the dealers or authorities could sort out the network.

POTENTIAL REFORMS

An immediate measure (one raised by Bernanke and Paulson and currently being explored by the major dealers) is to organize a clearinghouse for settling derivative positions. One possible clearinghouse arrangement is to make the derivatives exchange-traded, on an exchange such as the Chicago Mercantile Exchange. On such exchanges, the trade price is determined by the two traders, but the exchange itself becomes the counterparty for both traders. A second form of clearing house is to allow the dealers to net their obligations to each other, illustrated by the check-clearing mechanism in major financial centers. The major banks in New York City, for example, have daily claims in trillions of dollars on each other, but the clearinghouse allows them to clear the net amounts efficiently at the end of each business day. Both exchanges and check clearing houses solve the problem that a participant could default on its obligations by creating a mutualized entity through which the participating brokers or banks agree to share in any possible losses. This mutualization also creates a form of market discipline, since each of the participants has a clear incentive to police its partners.

The problem with both of these measures is that they require that only a limited number of standardized contracts be traded. As on exchanges, there would have to be only a

limited number of reference events or firms, notional amounts, maturity dates, strike prices, and the like. In contrast, the strength of the current OTC system arises precisely because traders highly value the ability to tailor an endless variety of derivatives to match their precise needs. Thus, squeezing OTC derivatives onto a clearinghouse or exchange would eliminate the very diversity that has made the market so important and useful.

This leaves us with the initial problem, namely that, for better or for worse, the Fed has effectively guaranteed the liabilities of the largest investment banks, and in particular their books of impaired and illiquid structured financial investments such as MBS and CDOs, thus creating moral hazard for these banks to engage in excessively risky transactions. The result is that the normally constructive role of market discipline has weakened, because bank creditors now anticipate that the Fed will step in to rescue them. In other words, without further regulatory responses, the next crisis will likely be soon in coming and quite possibly even greater in magnitude. With this definition of the problem, we turn to our proposed solution.

REGULATORY RESPONSES

The Fed's unprecedented actions to avoid a Bear Stearns bankruptcy provide a prima facie case that the regulation of investment banks must be expanded. Bernanke and Paulson agree that any new regulation must be integrated with strong market discipline. However, for market discipline to be effective, investment banks must be allowed to fail. It will be difficult, if not impossible, for the Fed and the Treasury to square these two goals under the current regulatory regime. Indeed, market discipline during the Bear Stearns crisis took the destabilizing and destructive form of a bank run. The markets will not believe that the Fed will allow market discipline to run its course until it allows a major bank to fail; however, a Fed threat to do so is not credible as long as the investment banks remain too interconnected to fail. Thus, regulation must be reformed to eliminate the link through which losses on an investment bank's investment portfolio threaten its ability to meet its obligations as a central counter party in derivatives.

Our proposal is to improve investment bank regulation by separating the firms' investment activities from their derivatives counterparty activities. This separation would recognize that the counterparty system now parallels the payments system as a fundamental component of the financial system's infrastructure. The payments system and OTC derivatives system both create a network of interconnected positions and the resulting vulnerability that the failure of a large and central participant could create a cascade of failures and thereby a systemic failure. The regulatory structure that has successfully protected the U.S. payments system thus offers a template for protecting the counterparty network from risky investment activities. Current federal commercial banking law provides for a well-defined hierarchy of entities:

- U.S. commercial banks may only carry out a "banking business"—primarily issuing deposits and making loans.
- U.S. bank holding companies may carry out activities "closely related to banking," as designated by the Fed. These permitted activities include the ownership of one or more commercial banks. A bank holding company that meets the Fed's highest risk-based capital rating—"well capitalized"—may also be certified as a "financial holding company."
- U.S. financial holding companies may

carry out an even wider range of financial activities, most importantly investment banking and insurance.

This hierarchy structure operates, however, under the clear understanding that the holding companies operate to protect their commercial banks and not the other way around. For example, special conditions of profitability and capital adequacy must be met before capital can be transferred "upstream" from a commercial bank to its holding company. This regulatory system has performed well since it was initiated almost 10 years ago.

Our proposal is to create a comparable separation of an investment bank's counterparty operations from the risks and possible losses in its various investment activities. As mentioned above, U.S. investment banks currently operate (among others) two separate business lines: (i) running hedge-fund like trading operations that maintain a highly leveraged and maturity-mismatched portfolio of risky investments, and (ii) operating as market-makers and primary counterparties in the OTC market for financial derivatives. Absent separation of the two activities, market discipline will not eliminate the incentive of an investment bank to use the Fed's liquidity backstop as a means to take excessive risks in its trading operations.

Separating the risk-taking trading from the derivative counterparty operations thus seems to be the only way to implement Secretary Paulson's prescription that market discipline play a role in future investment bank regulation. The counterparty subsidiary would be closely supervised and regulated to ensure it could operate safely and dependably on a stand-alone basis. The trading operations, in contrast, would continue to have limited regulation, but any losses would fall entirely on the debt and equity owners of the investment bank. These investors would thus have every incentive to enforce market discipline on the investment bank's risk management activities. The Fed's only action with a failing investment bank would be to spin off the counterparty division to a stand-alone firm or to merge it with another sound derivative dealer.

If our regulatory system had been in place two years ago, the Bear Stearns bailout could have been avoided, for two reasons. First, with a recognition that regulators would have no need to bail out an investment bank suffering even severe investment losses, lenders would have been more reluctant to provide funding for the highly leveraged, maturity-mismatched, and fundamentally risky Bear Stearns investment portfolio. In other words, market discipline would have acted to force Bear Stearns to limit the investment strategy that was the source of the losses that precipitated the firm's failure. Second, even if Bear Stearns had succeeded in obtaining funding for its risky investment portfolio, the Federal Reserve would have had no reason to bail out the firm, since the counterparty network of derivatives would have continued to function normally while the Bear Stearns investment portfolio was being liquidated by the firm's creditors.

IN BRIEF

Our proposal is to apply the principles of the existing commercial bank holding company laws to separate investment bank counterparty obligations from their investment portfolio risks. This would require new legislation to parallel the existing Gramm-Leach-Bliley Act of 1999, which relaxed Glass-Steagall by allowing a well-capitalized commercial bank to own an investment bank. Under our proposal, an investment bank could continue to carry out both trading and derivative counterparty activities, but new

legislation would safeguard all derivative counterparty obligations from losses that might arise from risky investment bank trading portfolios. In this manner, regulation and market discipline would combine to protect the financial system's infrastructure, without creating unnecessary regulatory burdens.

Letters commenting on this piece or others may be submitted at http://www.bepress.com/cgi/submit.cgi?context=ev.

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