AFTER THE FALL III

# FINANCIAL ENGINEERING

*Investment banks should be allowed to innovate and take risks, but must bear the full cost of any mistakes, says DEEPAK LAL*

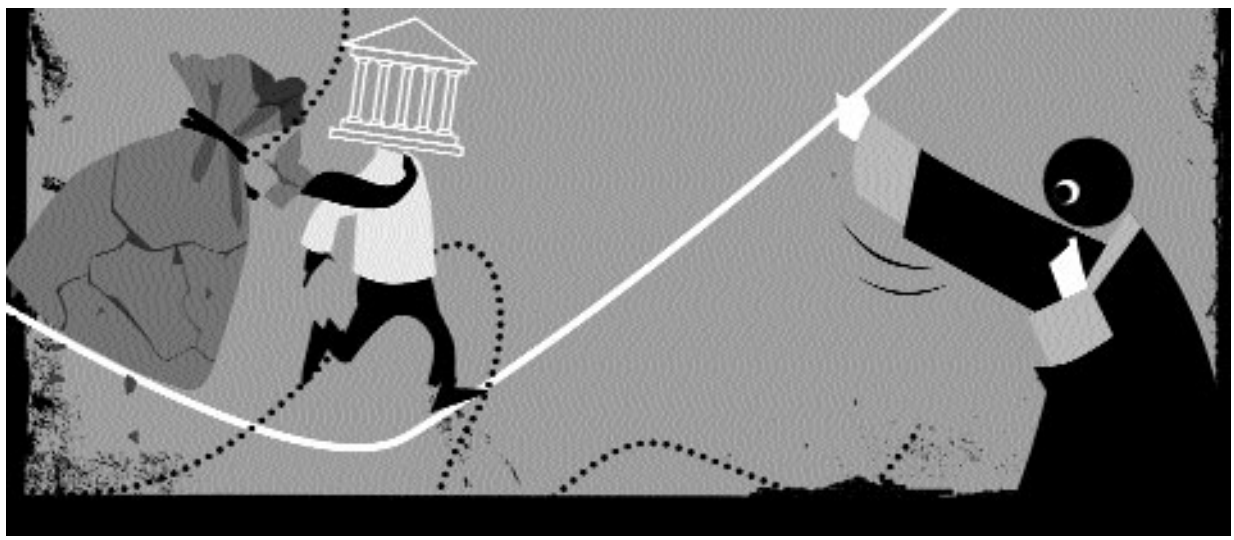

ILLUSTRATION BY BINAY SINHA

The story of financial engineering, which created more and more complex debt instruments in which tail risk was ignored, is well known (see Gillian Tett: Fools Gold; Raghuram Rajan: Fault Lines). It was induced by the low interest rates during the Great Moderation, and exacerbated by the Greenspan Put. Two lessons, however, are important. First, (as argued in my last column) it was the policy of the US government, ever since the Great Depression, to promote housing through the financial system which led to the subprime mortgage crisis. Second, it was the moral hazard begun with the LTCM bailout, and the subsequent bailouts of financial firms which were not commercial banks and whose bankruptcy did not threaten the deposit base, which led to the mispricing of risk: with financial intermediaries coming to believe that if their increasingly risky bets were successful, they stood to make immense financial gains, and if they turned sour, the authorities would get taxpayers to bail them out.

These distortions in the US financial system were then internationalised by asset-backed securities which increasingly came to be held by banks around the world. Packaging a host of different securities, including subprime mortgages, into increasingly opaque securities in the belief that this diversification of the assets in each security basket would lower the risk of holding the security, made these securities even more insecure. It was like packaging different types of meat into pies and selling them around the world. When then it turned out that there was an infected piece of meat which had been baked into many of the pies in the form of subprime mortgages which turned sour with the downturn in the US housing market, none of the holders of the pies around the world knew if their pies contained the infected meat. All interbank lending based on these opaque, asset-backed securities ceased, and a global financial crisis was triggered.

The immediate official response to the crisis, in which the insurer AIG was bailed out, which then led it to fully repay its counterparties like Goldman Sachs, bailing them out in turn, only justified the beliefs of those who had undertaken the imprudent lending that any losses would be borne by taxpayers. Moral hazard increased even further. It was further accentuated with the classification of institutions as being "too big to fail", and has given an incentive for the creation of even larger universal banks "too big to fail". With the authorities egging on the conversion of previous investment banks into bank holding companies, the US financial structure has become even more oligopolistic.

Much worse, the recently passed Dodd Frank Wall Street Reform and Consumer Protection Act now formalises the Federal Reserve's role in being the supervisor and lender of last resort of the whole US banking system. There is some obeisance to separating the "gambling" investment from the "utility" commercial banking part through the Volcker rule. Though, as the *Financial Times* reports, the Wall Street banks have already found a loophole which allows them "to continue to invest billions of dollars of their own capital in spite of new rules aimed at stopping them from taking risky bets" (November 11, p.16). As they are now universal banks, they can continue gambling, knowing that they will be bailed out if their losses threaten the deposit base.

As I and many others have argued, as long as there is deposit insurance, something like the Glass-Steagall Act separating investment from commercial banking needs to be instituted. There is, however, the alternative view that the Glass Steagall Act had already been eroded, and its repeal was a sensible measure of deregulating the financial system. Much of this argument is based on assessing whether the Glass Steagall Act was necessary or an immoderate response to the Great Depression. Calomiris (US Bank Deregulation in Historical Perspective, Cambridge, 2000), citing many studies which have examined the claim that there was a conflict of interest in mixing commercial and investment banking, whereby "banks might coerce client firms or cheat purchasers of securities", argues that this argument has now been discredited. But he also notes that another concern behind the Glass Steagall Act "was largely that of economists who correctly worried about the abuse of deposit insurance and the discount window — the possibility of government subsidisation of risk in new activities" (p.xiv). This is the worry which has not gone, particularly as he notes that deposit insurance is the only part of the 1933 Banking Act which now remains "and it is difficult to imagine circumstances that will lead to its repeal" (p.xviii). This is the nub, and it is difficult to see why he would, therefore, oppose keeping investment and commercial banks separate. It is deposit insurance alone that provides a reason for public regulation of any aspect of banking. If the Glass Steagall firewall between commercial and investment baking is maintained, there is no reason why the investment banks should not be set completely free. They should be allowed to follow whatever innovations and risk-taking they choose in competitive markets, but must be made to bear the full costs of any mistakes.

By contrast, under the Dodd Frank Act, as Peter Wallison of the American Enterprise Institute (Fiancial Services Outlook July-August 2010) has argued, all "financial firms will, under this new structure, inevitably be subordinated to the supervisory judgments about what the firms can safely be allowed to do... Where financial firms once focused on beating their competitors, they will now focus on currying favour with their regulator, which will have the power to control their every move. What may ultimately emerge is a partnership between the largest financial firms and the Federal Reserve — a partnership in which the Fed protects them from failure and excessive competition and they, in turn, curb their competitive instincts to carry out the government's policies and directions". In short, it is likely to substitute a sclerotic corporatist economic model, replacing the highly competitive and innovative model which, despite its flaws, has brought untold prosperity around the world.