

Obama's bank reforms: the Ryder Cup of banking?

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Summary

President Obama's proposed reform of US banks has not received universal acclaim. In particular, the UK government's response has been rather lukewarm. What I think we are seeing are different responses to the same short term political challenge, ie bank bonuses that laugh in the face of suffering tax payers who have made the continued payment thereof possible. US and European (well, British) responses to this challenge are very different. They risk damaging consensus on global banking reform.

Analysis

President Obama signalled a significant change in direction last week, with his proposals to limit the activities of banks. He had previously shown little appetite to interfere with the structure of US banking groups, but simply identify those activities posing the greatest risk and use regulatory and market solutions (eg increased capital requirements) to increase control and/or decrease risk.

Why the change of approach? Well Obama is an angry man. He has, twice within one week, denounced bank bonuses as "obscene", and one can only marvel at the sheer stupidity of senior bank executives announcing record payouts (primarily to themselves), only one year after being saved from oblivion by taxpayers. Whilst many of their saviours continue to suffer real declines in income, as a consequence of both pay cuts/freezes and tax increases, the recipients of their charity find it appropriate to compensate themselves for their forced sacrifice in 2008. Obama has every right to feel angry, having behaved responsibly in tackling the financial crisis, and avoided the temptation to behave in an overly populist manner in response to ongoing fury at previous bank excesses. He is entitled now to feel angry.

However, the question remains, are the proposed reforms driven by emotion or logic? Looked at from the eastern side of the Atlantic, they appear emotional. However, we have no history of banking organisation of the Glass-Steagall variety. I suspect from a US perspective, the reforms look more like "returning closer to what we know". If there is a feeling that pre-1999 regulatory structures kept banks and their executives under control, including control over remuneration, then the changes look logical.

I think the choice of "risky" activities is interesting. Quite why private equity is in there is not apparent to me. Private equity did not cause the financial crisis, nor is it likely to cause a systemic banking crisis in future. Many would argue the same with hedge funds. However, I can see some logic to including these in any restrictions. The credit crisis began with the insolvency of two Bear Stearns SPVs back in August 2007. Bear Stearns took these onto its own balance sheet to protect lenders from losses, and this ultimately led to its own demise. The same happened to many other institutions. However, the vast majority of non-traditional investment vehicles, ie hedge funds, played no direct part in the financial crisis. Indeed, some would argue that many hedge funds have, in fact, been victims of the crisis, not causes of it. So why single them out for exclusion from banking activities? I think there are two reasons, both of which combine an element of risk control logic whilst also achieving the President's immediate political objective of targeting future bonuses.

The first reason is that there is a link between a number of hedge fund strategies and the underlying cause of the financial crisis. The enthusiasm with which the providers of residential mortgages allied with investment banks to create vast amounts of mortgaged backed securities ("MBS") was a major cause of the crisis. These vehicles were able to circumvent the capital adequacy requirements of the banking system, and the reduced level of capital they carried proved totally inadequate when delinquencies increased from their historically low level.

The second reason for including hedge fund activity is simply that they are a major contributor to profits and bonuses. The above origination/distribution model for MBS resulted in very high bonuses for the staff involved. Not any more. Which brings us on to the main item in Obama's list: proprietary trading. This is where most of the offending bonuses have arisen, and the most infuriating aspect of this has to be the fact that the profits have been earned on the back of cheap money provided courtesy of the Fed. In the case of Goldman Sachs and Morgan Stanley, it is compounded by the fact that they are only eligible for these funds because of their hasty registration as banks in 2008, without which they would have failed.

The banks are, not surprisingly, far from enthusiastic about Obama's proposals. However, they have (perhaps) unlikely allies in at least one government. Alastair Darling, the UK's Finance Minister, has given very little support to them, and this is critical given the UK's status as the other major global financial centre. Whilst Darling is doing a lot of other things to undermine that status, it is interesting that he clearly does not see the kind of "separation of powers" of size limits as being of much value in preventing a similar financial crisis in future. He was unequivocal in saying that Obama's proposals might undermine G20 consensus on global bank reform, and he has made it clear that he has no intention of pursuing similar reform to banks based in the UK. I actually support Darling's views here. The current crisis was not caused by one or more banks being too big to fail. Rather it was caused by a collective failure of confidence amongst all credit institutions, such that none were willing to extend credit to any other. The institutions that did in fact fail, in both the US and UK, were not systemically important individually (Lehman Brothers in the US, Northern Rock in the UK).

So what about the UK response? The anger about bank bonuses is just as great here as in the US. Goldmans' senior executives in London limiting themselves to no more than £1 million each in remuneration this year is not being received with joyous thanks by the general populace which, like its US cousins, cannot understand how a 6% fall in GDP over the last 18 months, record peacetime government deficits, increased taxation, reduced real incomes, and unemployment at a more than 10 year high, translates into record remuneration for the causers of all this suffering.

Darling's solution to this (political) problem was to impose a 50% payroll levy on all bank bonuses in excess of £25,000, such levy not to be an allowable expense against corporation tax, thereby increasing the real after-tax cost of the levy. When the levy was announced, Darling expected it to raise £550m in revenue for the UK Exchequer. Now we are told it is likely to raise more than 4 times this amount. In other words, it has not discouraged payment of bonuses. What appears to have happened is that global banks have spread the cost of this bonus across all staff globally, thus minimising the impact across all staff. So that option for curbing bonuses, whether short term or long term, does not appear to work. Taxes like this will never be adopted globally so, based on UK experience, Obama would be right to reject this option if he wishes to curb excessive remuneration. It does not appear to work.

What Obama and Darling are both trying to do is force more sensible remuneration behaviour across financial institutions. Both face important electoral tests in 2010. Both are in political difficulties. It is hard to see the UK government being returned to power for a fourth term, whilst the loss of a Massachusetts Senate seat held for the last 50 years by the Democrats looks more than unfortunate. Resorting to populism is clearly tempting on both sides of the Atlantic. We are just seeing alternative populist responses.

I suspect we will see a significant watering down of the Obama proposals, matched by some equally significant changes in remuneration policies at certain banks. The short term political problem might be defused somewhat if senior bank executives made some generous donations out of their bonuses. Redirecting these to, say Haiti reconstruction, rather than their favourite Congressman's re-election fund, might be a good start.