

President Obama and the Bankers

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The announcement made by President Obama from the White House on January 21st concerns an in depth reform of the financial system. Clearly the sheer scope of the crisis, which was caused by malfunctions in the financial markets, justifies a reconsideration of the legal, regulatory and operational framework of the system.

Several of the President's proposals, which at this point remain fairly vague, raise questions and render an already very complex debate even more obscure for the public at large. Two main themes are addressed: first a general objective to shield the taxpayer from future bail outs of troubled financial institutions and second a specific objective to control excessive remunerations that were generated by the current system.

A preliminary criticism is in order: whatever the merits of the presidential proposals, their unilateral character – Made in USA – weakens them from the outset. If there was a single lesson to be learned from the crisis, it was the "global character" of financial markets, characterised by quasi instantaneous transmission mechanisms and worldwide accessibility. Even if there is a certain amount of frustration due to the slow pace of the work of the G20, it remains the only "political" forum where the necessary coordination of the reforms can take place.

By taking the initiative of imposing a reform of the structure of its financial sector, the President is taking the risk of provoking reflexes from the international community which, at best, will further slowdown the pace of reform; at worst, one can fear the surfacing of financial protectionism, destroying the very foundation of prosperity which is built on a well regulated free market.

Let us now examine each of the objectives defined here above.

The restoration of a separation between different types of financial activities on a model inspired by the Glass-Steagall Act of the 1930's certainly deserves an in depth examination and the endorsement of the presidential proposal by Paul Volker is sufficient to warrant their consideration. It appears appropriate to consider separating the traditional activities associated with "commercial" banking from those that characterise "investment" banking, all the more that he formerly benefited from a public "guarantee" scheme.

To ensure the viability of commercial banking, a framework of coordinated regulatory measures is indispensable; they include: an adequate ratio between capital and liabilities (solvency), an appropriate spread of credit risks and access to the necessary financing requirements (liquidity). These regulatory constraints must also cover an evaluation of the competencies of management and operational methodologies.

The topic concerning the solvency ratio is regulated by the "Basel Accords" and is subject to further consideration by the Financial Stability Board which will submit its findings to the G20. It is clear that the recommendations should be closely related to the question of "permissible" activities of commercial banks.

The spreading of credit risks must aim at prohibiting banks to have an excessive exposure to a single borrowers, to a specific economic sector or to any group of borrowers whose solvency is correlated (as proved to be the case in the American real estate market). The framework regulating this imperative should be sufficiently flexible to take into account developments in the economy, markets as well as innovations.

On the question of liquidity, which played such a central role in the spreading of the financial crisis, it is necessary to implement a more robust structure so as to minimise, to the extent possible, the "domino" effect of a seizure of the interbank market. In the face of this seizure that was initiated in the summer of 2007, monetary authorities, i.e. Central Banks, reacted vigorously and were able to prevent a "systemic" breakdown by offering banks quasi unlimited access to an alternative financing source. Furthermore, when the crisis spread from the financial sector to the economy at large, the official interest rate was progressively reduced to practically zero, which is not without consequences in managing crisis "exit" strategies, nor in the accumulation of extraordinary profits accumulated by some financial institutions in 2009.

For the future it is imperative to create a system that makes the interbank market secure and minimizes the need for recourse to Central Bank financing. I had already suggested in October 2008, the creation of "Clearing House" for interbank transactions where the "net" position of each participant would be secured by the pledge of eligible collateral. Such a mechanism would reduce considerably recourse to Central Bank financing which could be subject once again to dissuasive interest rates restoring an additional measure of flexibility to monetary policy. The system should be open to other financial institutions such as investment banks which would find an alternative to the need for direct access to the Central Bank. Institutions such as Goldman Sachs or Morgan Stanley could escape regulatory supervision by the Federal Reserve Bank into which they were compelled by the virtual closing of the interbank market.

There would be no particular reason to forbid commercial banks to be active in areas where they can provide financial services to their clients, for instance portfolio management (private and UCITS), the execution of customer orders on regulated markets, corporate finance advice in mergers and acquisitions etc. These activities should, however, exclude taking "principal" positions on the books of the bank as counterparty to transactions initiated by client unless it is within the scope of the normal activity linked to the granting of a standard credit line.

By limiting the scope of activities open to institutions that solicit client deposits and by regulating the type and spreading of risks, it would be possible to limit the level of the solvency ratio. Indeed, one can avoid including in the solvency tests extreme stress hypothesis which would be needed to take account of the risks associated with proprietary trading. As a quid pro quo for limiting their activities, commercial banks could enjoy a lower level of their solvency ratio, boosting correspondingly their return on own funds.

As for investment banks, they would be prohibited from soliciting client deposits. On the other hand, they would remain free, within the appropriate regulatory framework, to operate freely in markets for their own account band as counterparties to their clients and the market, while remaining subject to the rules concerning the segregation of customer assets, the compliance with existing laws, regulations and codes of conduct governing transparency, dissemination of information, conflicts of interest etc., as presently in force.

With regard to the financing of their operations, investment banks would be treated as any other commercial bank customer, i.e. subject to limits it could borrow from any single bank. As previously suggested, they could become members of the interbank Clearing House, limiting the risk they represent to the market in case of failure, their commitments being adequately collateralized to guarantee the unwinding of their open positions.

In light of the foregoing, should one conclude that a total legal separation is required between commercial and investment banking activities? Not necessarily. Indeed, it is perfectly plausible to envisage a holding company structure within which the different subsidiaries remain legally separate entities (as is the case in the insurance industry where the financial stability of AIG's insurance affiliates was not impaired by the quasi failure of the parent company, brought down by the unregulated AIG Financial Products subsidiary).

It is indeed perfectly legitimate for a financial institution to have the ambition to cater to the full range of financial needs of its customers, as long as this does not put in jeopardy the stability of the financial system.

Two additional remarks concerning the security of markets are called for.

There does not appear to be sufficient objective reasons to limit the size of financial institutions to the extent that the measures discussed here above form a fully coherent framework. Size should, however, be one of the elements considered in the determination of the appropriate solvency ratio, adjusted as a function of the institution's risk profile as well as the general economic environment.

The second remark concerns the national deposit insurance schemes which are at the centre of preoccupations when it comes to protect the financial markets from systemic risks. I refer here to my earlier suggestion recommending the implementation of a bank licensing system which would require - within the framework of national legislations - the acceptance by commercial banks of a series of obligations including the exchange of information on accounts benefitting from a public guarantee. This measure, aimed at fighting against fraud, would be specifically accepted by the depositor in exchange for the guarantee making him personally responsible for his choice. Banks who would not be licensed would face an insurmountable commercial disadvantage as they would not be able to offer deposit protection to their customers.

Let us now consider the specific objective of establishing an appropriate framework for staff remuneration.

Whatever disastrous image has been projected by the announcement of large bonus payments for 2009 by a number of financial institutions when the crisis, which originated in the financial sector, is far from over, the link made by President Obama between the level of profits and a return to old practices of "business as usual" is far from being justified.

Indeed, a significant amount of the profits realized by institutions having direct access to Central Bank funding derives from a straight forward and very lucrative arbitrage between the quasi zero rate of borrowing and riskless investments, mainly in securities issued by governments and government entities. In these conditions it is plainly wrong to talk about excessive risk taking.

On the other hand one may regret that the liquidity, so generously provided to the market, has not found its way to financing business undertakings. This is attributable in part to a reduction in demand for credit resulting from the crisis and in part to the imperatives of rebuilding the bank's capital base and managing risk exposures required by the Regulators, despite the urgings to the contrary by political and sometimes monetary authorities.

This puts clearly into evidence the contradictions generated sui generis by the system by which the perpetuation of an accommodative monetary policy aimed at underpinning the recovery induces unexpected and less than satisfying results.

It is a paradox that the profits reported last week by Goldman, Sachs may actually point the way to resolving the question of excessive remunerations while simultaneously avoiding the trap of discriminatory treatment.

The fourth quarter results took the market by surprise by posting profits in excess of USD 8.00 per share against a consensus forecast of USD 5.20. This gap is easily explained by the decision of management to substantially reduce the level of the "provision for staff compensation" by making no contribution at all in the fourth quarter and reducing somewhat the level accumulated at the end of the third. As a result the provision stands at year end at less than 38% of gross revenues against an amount averaging around 50% in the previous years. The accounting effect is to increase profits both before and after tax. The purpose, which was commendable though not necessarily achieved, was to placate the anger of public opinion egged on by the media and politicians in the condemnation of excessive bonus payments.

What lesson can be drawn from this apparent about turn of Goldman, Sachs's management? The answer is that excessive bonuses should be classified from an economic point of view as "dividends" rather than as "remuneration".

My proposal is the following: any bonus in excess of USD 38,000 (GBP 25,000 – EUR 27,500 to retain the threshold amounts of the French and British exceptional tax on bonuses) would not be tax deductible and be paid out of net profits after tax. As such, these payments would be subject to shareholder approval when they vote on the allocation of profits. Such a classification of bonuses would be much more in line with their true character and would align far better the respective interests of beneficiaries, shareholders and the taxpayer through the additional tax revenues generated. Nothing would stand in the way of retaining the rules covering the spreading of payments over several years as well as claw back provisions. When distributed, these amounts would be added to the ordinary income of the beneficiaries in the year received.

Let us note that this concept could – and maybe should – be extended beyond the financial sector to all economic agents and specifically to company directors. From the point of view of social justice and considering the need of governments to find new sources of revenue, there is no good reason to exempt from the mechanism any compensation exceeding the contractual salary augmented by a discretionary but limited bonus.

This simple measure, easily transposable with the necessary flexibility into national legislations, would be a first step towards a new economic and social environment which everyone feels is indispensable though few are ready to assume the responsibility of its implementation.

On the basis of the proposals made here above (or of similar ideas) it is not too late but high time to build a consensus around the questions that were legitimately raised by President Obama. If the opportunity is squandered, it is to be feared that very rapidly the temptation of protectionism will gain the upper hand with its disastrous economic and social consequences.

Chang Mai, January 28th 2010

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