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Tightening up the rules - again

Minos Zombanakis is credited with the development of the Euromarkets. He arrived in London in 1969, to set up Manufacturers Hanover Ltd moving to First Boston a few years later. His contribution lay in the syndicated euroloan market and in the development of LIBOR. He is chairman of the CSFI's Board of Trustees. For the last 30 years, he has run an annual seminar in Greece, bringing together US, European and Middle East policy-makers.

Following the crash of 1929, and the resulting bankruptcies of banks and business enterprises, the US Congress proceeded to pass - the Glass-Steagall Act. This separated commercial banks from investment banks.

Under Glass-Steagall, commercial banks became "public utilities" governed by strict supervision. Even interest rate levels were fixed by Regulation Q. Emphasis was placed on the solvency of banks, with strict guidelines as to what portion of their capital could be exposed to a particular borrower. As a result, profits to shareholders were generally low, and operating expenses were strictly controlled. It was said, for example, that if you could not find a job in the government, you tried to get one with a commercial bank - meaning that remuneration for employment at a bank was lower than that for employment by the government.

This continued until the middle 1960s, when Walter Wriston, the chairman of Citibank and the undisputed leader of the US banking profession, came up with the pronouncement that commercial bank shareholders had the same rights as shareholders of other industries to maximize their profits. BANG! Citibank, and subsequently the rest of the US banks, replaced solvency as their main objective with 'profit centres'. Departments and branches were given profit targets and a tough timetable for achieving them – which, naturally, pushed them to grant loans with higher risks. It was the beginning of a new era.

As lending expanded, banks had to raise more capital - either by issuing new shares or through mergers with other institutions. However, such mergers were tightly controlled by the Justice Department. If you wanted to merge, you had to prove that the merger would not compromise the competitiveness of the industry.

Just a few years later, the Eurodollar market was being established in London and the concept of LIBOR emerged – permitting the mobilization of funds to finance the requirements of sovereign countries, often from groups of banks. Initially, some banks were reluctant to participate in such consortia, if for no other reason than that they were losing their bilateral relations with particular borrowers, and thus had to forgo the collateral benefits in the form of deposits, the financing of commercial transactions etc. However, this reluctance did not last for long.

Soon afterwards, there was a sharp increase in the price of oil. This meant large surpluses in oil-producing countries that had to be recycled to finance the deficits of the oil-consuming countries.

The enormity of the amounts involved and the urgent need to satisfy the demands of the deficit countries broke all the rules and regulations under which the banks had been operating – albeit with the full knowledge and consent of the authorities. The major role in the recycling was undertaken by US banks; the Federal Reserve and the Treasury considered it a plus for America that the rest of the world depended on US banks for its financial requirements. The fact that these banks were providing loans that were sometimes larger than their own capital to individual countries, especially in Latin America, was totally (and conveniently) ignored. Inevitably, when some of these countries that had borrowed huge amounts could not service the debt, the LDC crisis started.

As part of the 40th anniversary celebrations of the Bretton Woods system, the Federal Reserve Bank of Boston invited a group of people (including myself) to a gathering in Bretton Woods, New Hampshire. That same day, Continental Illinois declared bankruptcy.

An attempt was made to get Chemical Bank to take Continental over, but when that failed to materialize, the Fed stepped in – guaranteeing depositors for amounts way above FDIC limits, instead of allowing the bank to fail. A few days later, the then Secretary of the Treasury, Don Regan, announced that the US Government would not allow any big bank to fail.

Following that announcement, US banks felt themselves liberated; they could chase any new loans in order to increase their profitability, without paying attention to the magnitude of the risks they were taking on. As a result, the exposure of the banks became so enormous that - practically speaking - no US bank was solvent. The authorities pretended not to see this. Instead, they encouraged banks to merge with each other, ignoring anti-trust legislation. Plus, they helped in other ways. For instance, as the US banks struggled to survive, monetary policy changed, and the banks were able to rebuild their capital through a 'positive carry' on Government securities.

As the banks recovered from that crisis, they began thinking of other ways to maximize their profits. As a result, they started to finance LBOs, private equity funds, hedge funds, and whatever else sprang up in a deregulated environment – knowing that the Government would not allow them to fail, despite the risks they were taking.

They were right. Indeed, pressure for further deregulation was exerted on Congress and the regulatory authorities, culminating in the formal abolition of the Glass-Steagall Act in 1999 - allowing commercial banks to compete directly with investment banks in all kinds of transactions. Anything could be financed - provided only that it appeared profitable. At the same time, derivatives mushroomed – and, increasingly were carried outside the balance sheets of the banks, in the belief that, since every transaction had a counterparty, they were essentially self-liquidating. It is estimated that these off-balance

sheet items now amount to about US $60 trillion - in other words, four times US GDP. Unfortunately, as some counterparties have failed, banks have had to subtract their losses from their capital - a 'Sword of Damocles' that still hangs over their heads.

In 2008, the balloon burst.

What should be done from now on? Here are some thoughts:

1. All commercial banks should return to the *status quo ante*, i.e. they should go back to "utility banking", tightly supervised by the relevant authorities. Emphasis should be placed on the solvency of such banks, as was the case before Walter Wriston changed the game.
2. The investment banks ("if any survive") should return to their old functions, i.e. advising their corporate clients and arranging for their equity and debt requirements.
3. Fund management companies should continue to function - but their fee structure should be regulated by the SEC and by the relevant agencies in other countries. And investors in such funds should know the leverage, if any.
4. Hedge funds should be abolished unless they submit themselves to strict supervision. They should be incorporated in the countries where they operate. No offshore companies should be involved, so that transparency can be achieved. Their fee structure should be regulated by the appropriate Supervisory Authorities. Leveraging should be made public so that investors know what risk they are undertaking.
5. Private equity firms should not be allowed to acquire companies unless they can convince the appropriate authority of the validity of such an acquisition. Mergers and acquisitions should be subject to the approval of the State Authorities, as was the case in the past, taking into consideration monopolistic tendencies - and definitely not at the cost of labour dismissals.
6. Securitisation of bundles of assets should be closely examined, and guidelines should be given by the Regulators on the composition of instruments to be included. The financing of trade should be carried out by commercial banks, but only for self-liquidating transactions. Banks can also provide working capital, but should make sure that such funds will not be frozen as long-term debt.
7. As for the rating agencies, it is a scandal that they are not more strictly supervised. A Supervisor is needed to make sure that there are no conflicts of interest involved, and that the ratings are not arbitrary.

The role of the US dollar – which remains the predominant currency of both transactions and asset accumulation - creates enormous problems for the rest of the world, since it dominates global savings, and permits the US to finance its deficit to the detriment of the system. It also relieves the US Government of the need to exercise fiscal discipline - resulting in the situation we are in today, in which the United States depends on China and Japan in order to survive.

- Back to "utility banking" – with tight supervision of commercial banking. Investment banks ("if any survive") limited to corporate advisory work and capital-raising.
- Much tighter regulation of fund management – including transparency about leverage and regulation of fees.
- A new supervisor for the rating agencies?
- Let's have a real debate over moving to a multicurrency world – with the dollar sharing its role with the euro and a regional Asian currency.

As a result, we should seriously reconsider the recommendations made by the Bretton Woods Commission in the early 1990s, particularly on the need to develop 'parallel' currencies for transactions and for reserve asset accumulation.

Since the Commission reported, the euro has been created – with a generally positive impact on both the European economy and on the rest of the world. A similar Asian regional currency is badly needed – particularly given the threat to the global payments system posed by the enormous size of US liabilities to the rest of the world. So let's have a real debate over moving to a multicurrency world.

Finally, we must work together to strengthen multilateral institutions like the IMF – and we should let them operate under their original mandate. In the case of the Fund, that means as a provider of short term balance of payments support.

In my view, the financial system can only justify its existence if it helps to finance trade and development. It is not there to turn the world into a giant financial bazaar, and it is not there to allow a few smart bankers to enjoy huge riches at the expense of society.