‘No’ to Reforms

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Ayear ago, as banks were on the brink of collapse and Western governments spent trillions of dollars to bail them out, it seemed there would be reforms to rein in the banks' power and change the rules to prevent another crisis.

Yet to date, there have been few basic changes to the rules. Many analysts believe the opportunity for making the needed reforms, at the height of the crisis, may have passed and that the banks and their powerful lobby groups have re-asserted themselves. The danger is that there will be a return to business as usual, until the next crisis.

Nevertheless, there are still powerful figures voicing the need for various reforms. Whenever they speak up, there is a negative response from the banking industry, claiming the proposals won't work and will have negative results.

Though the momentum for reform may have waned, the fight continues. The issue that has most captured media attention is the attempt to curb excessive salaries and bonuses paid to bank executives.

Public outrage continues because there is a return to such high bonuses, as those recently given out to Goldman Sachs bankers.

Two other issues that involve see-saw battles of opinion and possible actions are whether to impose a tax on financial transactions to curb speculative activities and whether to re-establish a firewall between commercial banking activities and risky operations like those carried out by investment banks.

The transactions tax has been championed by France and Germany. Then at the recent G20 finance ministers' meeting in Scotland, British Prime Minister Gordon Brown unexpectedly joined the advocates and proposed that the G20 consider the tax. Cold water was immediately thrown on this by the US Treasury Secretary Timothy Geithner, and Brown apparently retreated the following day, but a news report a few days ago suggested that he would still pursue the matter.

The aim of the proposed tax, often known as the Tobin tax, is to impose a small charge of below 1% on financial transactions so as to make speculative activities unpro-fitable.

Lord Turner, the chairman of the UK's Financial Services Authority, commented a few months ago that much of the financial activities in the UK do not have social value, and he proposed the transactions tax to curb speculation. But he was fiercely attacked by bankers.

Meanwhile, a big debate is taking place in Washington on whether there is a need to prevent financial insti-tutions from being involved in both commercial banking activities (which rely on depositors' funds) and in risky investment banking activities. Depositors' funds need to be protected and thus should not be subjected to the highly leveraged and risky investments in capital markets that can easily go wrong, as shown so spectacularly in the current financial crisis.

In 1933, from lessons learnt during the Great Depression, the Glass-Steagall Act, which was adopted by the US Congress, disallowed commercial banks from combining their commercial banking activities with other financial operations such as investment banking and insurance. This protected depositors and also prevented the financial sector from assuming too much risk.

This conservative approach had served the economy well but in 1999 this Act was repealed, opening the door for financial institutions to combine commercial banking with more risky financial operations.

Many believe that this major deregulation was one of the root causes of the current crisis. Because depositors' funds are involved, and the operations are so interlinked, the giant financial institutions have become "too big to fail" and to prevent their collapse, billions of dollars of public bail-out funds had to be spent.

Influential figures such as Paul Volker, the former Federal Reserve chairman, have called for the re-instatement of a law based on the Glass-Steagall principle, and for the big institutions to be broken up so that commercial banks stick only to their conservative business.

On Nov 5, the former long-time CEO of Citicorp, John Reed, a leading figure pushing for the repeal of the Glass-Steagall Act in 1999, apologised for his role in building this bank into a huge conglomerate combining commercial banking with other operations and called for a new law to separate the functions of the large financial institutions.

In 1998, Citicorp (a commercial bank) merged with Travelers Group Inc, which owned the investment firm Salomon Smith Barney Holdings, to form Citigroup.

The repeal of the Glass-Steagall Act in 1999 allowed this new combined entity to operate. Reed was the CEO of Citicorp for 14 years until it became Citigroup, which he then co-led until 2000. Citigroup was one of the institutions most responsible for the financial crisis as well as most affected by the crisis.

It lost US$27.7bil in 2008 and had US$118bil in writedowns. It was kept afloat by US$45bil in direct aid and much more in loan guarantees.

In an interview with the media group Bloomberg, Reed said reforms of financial regulations by the US Congress should include ordering banks to hold more capital, ensuring executive compensation is aligned with long-term profitability and banning firms that take deposits from also engaging in equities and fixed-income trading.

"I would compartmentalise the industry for the same reason you compartmentalise ships," Reed said. "If you have a leak, the leak doesn't spread and sink the whole vessel. So, generally speaking you'd have consumer banking separate from trading bonds and equity."

Reed added that the Congress was wrong to repeal the Glass-Steagall Act in 1999. He had supported the repeal, and now he says: "We learn from our mistakes."

According to Bloomberg, Citigroup pioneered the production of collateralised debt obligations (CDOs), bundles of loans turned into securities that were sold to investors. The CDOs lost value when sub-prime mortgage borrowers defaulted on their payments and this was a major part of the Citigroup's writedowns and losses.

According to Robert Weissman, president of the consumer group Public Citizen (founded by Ralph Nader), the repeal of Glass-Steagall in 1999 changed the culture of commercial banking to emulate Wall Street's high-risk speculative betting approach and this was an important factor creating the financial crisis.

Weissman makes the following proposals to clean up the mess:

—RETURN to Glass-Steagall's principle that depository institutions backed by federal insurance protection cannot be involved in the risky, speculative betting of the investment banking world;

—IN the same line, and more broadly, commercial banks should not be in the business of speculation. Their job is to provide credit to the real economy and not to engage in betting on derivatives and other exotic financial instruments;

—GIANT financial institutions exercise too much political power and for that reason alone must be broken up; and,

—BROAD reform in the area of money and politics including restrictions on lobbying and on the "revolving door" through which individuals spin between positions in government and industry. □□□

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