



# *Policy Note*

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## **WILL THE PAULSON BAILOUT PRODUCE THE BASIS FOR ANOTHER MINSKY MOMENT?**

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As the House Committee on Financial Services meets to hear the expert testimony of witnesses concerning the regulation of the U.S. financial system, the measures that have been introduced to support the system are being implemented and are laying the groundwork for a new domestic financial architecture. This process can be seen clearly in the disappearance of all the major investment banks and their reappearance as financial holding companies. The Federal Reserve (Fed) and U.S. Treasury seem to be supporting a model in which the funds made available through the Emergency Economic Stabilization Act (2008) are used by stronger holding companies, with substantial core deposits from commercial banking activities, to merge with weaker financial institutions. The *New York Times* reports that according to government officials, "The Treasury Department hopes to spur a new round of mergers by steering some of the money in its \$250 billion rescue package to banks that are willing to buy weaker rivals."<sup>1</sup>

The experience of the past weeks has led some to call for a return to a system similar to that created by the Banking Act of 1933. These discussions recall those that took place in the mid-1990s, when the United States contemplated liberalizing its financial system and debated the benefits of a universal banking system, as opposed to a system based on bank holding companies.

Before he died in 1996, Hyman P. Minsky was actively involved in these discussions. The unpublished drafts of his work show that he was not in favor of returning to a Glass-Steagall system

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of bank segregation because of the dramatic changes in financial innovations that had taken place since the Great Depression. In particular, he emphasized that money managers of large institutional investors, such as pension funds and insurance companies, had replaced the loan officer in decisions concerning the extension of credit.

However, Minsky highlighted one aspect of the Glass-Steagall Act (1933) that provided the basis for any reregulation of the financial system. "It was believed that the safety and soundness of banks and savings and loan associations were promoted by narrow definitions of their permissible activities," he noted. "In particular the scope of permissible activities by a depository institution was to be limited to what examiners and supervisors could readily understand. This objective of examinability and supervisability supported the separation of commercial and investment banking; it was not so much the differences and riskiness as it was the ease of understanding the operations that led to the separation of investment and commercial banking."<sup>2</sup>

This objective suggests that the basic principle behind any reformulation of the regulatory system should limit the size and activities of financial institutions, and should be dictated by the ability of supervisors, examiners, and regulators to understand the institutions' operations. The reorganization of the financial system that appears to be taking place with the backing of the Fed and the Treasury does not seem to respect this principle. Instead, it seems to support larger financial institutions that are created by merging weak institutions with stronger ones on the presumption that large institutions have a lower likelihood of failure. Experience, however, suggests otherwise.

There is clear evidence that part of the current financial crisis is due to the fact that regulators were unable to understand and evaluate the risks undertaken by even middle-sized financial institutions. Indeed, one justification for self-regulation recently proposed by large global banks was that regulators did not understand their activities. In addition, the report from the Senior Supervisors Group that deals with risk management,<sup>3</sup> in addition to frequent public declarations by top managers, suggest that the management of these financial institutions was similarly incapable of understanding and evaluating the risks undertaken by their institutions.

In written testimony to the House Committee on Oversight and Government Reform on October 23, 2008, former Federal Reserve Board chairman Alan Greenspan admitted that the

attempts to use self-regulation and counterparty surveillance have also failed: "Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity (myself especially) are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets' state of balance. If it fails, as occurred this year, market stability is undermined."

Thus, bank top management was no better informed than the regulators. In a *New York Times* article, Klaus-Peter Müller, head of the New York branch of Commerzbank for more than a decade, noted that bankers did not adequately understand these investments and relied too heavily on high-grade credit ratings from agencies that helped put together the products, then rated them. This ignorance of the risks extended to the top echelons of the banks. "Did I know in March of '04 that there was a U.S. subprime market" that was going to face serious problems in the next few years? said Müller. "No, I didn't have the slightest idea. I was a happy man then."<sup>4</sup>

Josef Ackermann of Deutsche Bank echoes the thought. At a July 2007 luncheon attended by chief executives of leading banks, political leaders, and senior Fed officials to discuss the looming risks to the financial system, the deepening woes in the subprime mortgage market did not figure high on the agenda, he said. "We clearly underestimated the impact on completely different asset classes."<sup>5</sup>

If the present trend of bank mergers continues, the resolution of the crisis will likely produce sizable banks and other financial institutions that cannot be regulated or managed; and, as Minsky always predicted, this "resolution" will lay the basis for another financial crisis. Government ownership and participation in banks will do nothing to alleviate the problem.

Minsky did not favor the introduction of universal banking as practiced in Europe: "The evidence from history indicates that such wider scope institutions are not necessary for the United States economy to do well." In general he supported a bank holding company structure because it would "allow banks and other businesses to be joined in an enterprise which has a wide range of subsidiaries, each subsidiary having its own assigned capital. A failure of a particular subsidiary would not impair the capital and the ability of other subsidiaries to operate." In light of the experience of AIG, this position seems excessively optimistic. However, it also seems likely that the bank holding company structure will remain the dominant structure in the United States.

Minsky also favored bank holding company structures because each subsidiary would have a relatively well-defined function, thereby making it easier for regulators—and examiners and supervisors—to understand the operations of the business. Thus, particular lines of business could be effectively and independently regulated within the overall holding company structure. Again, this suggestion seems overly optimistic, given our experience since the introduction of the Financial Services Modernization Act (1999) a decade ago.

That legislation provides two types of holding company structure: banks and other financial institutions that have a wider scale of financial market activities. A third alternative, which respects the basic principle that financial institutions should be organized in a way that can be efficiently and effectively regulated and supervised, would be the creation of numerous types of subsidiaries within the holding company, but with tighter limitations on the range of activities allowed each subsidiary.

In particular, the two basic functions of the financial system based on Glass Steagall could be preserved: that is, the provision of a safe, secure transaction system, and store of value, and the provision of sufficient financing at a reasonable cost for a productive investment. Holding companies providing transaction services, a store of value, or financing (for housing, consumers, or related activities) would then be limited to closely related activities only. A separate group of holding companies, with the appropriate related sets of activities, would provide underwriting and capital market services for the financing of productive investment. The aim would be to limit each type of holding company to a range of activities that were sufficiently linked to their core function and to ensure that each company was small enough to be effectively managed and supervised.

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