Humpty Dumpty and the Case for Bank Taxation

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Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance
by Viral Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter (Wiley 2010)

Many people in the City and on Wall Street are the financial equivalent of slumlords or toll collectors in pin-striped suits. If they retired to their beach houses en masse, the rest of the economy would be fine, or perhaps even healthier.

Thus did John Cassidy, citing Lord Adair Turner, Chair of the British Financial Services Authority, shock New Yorker readers by explaining that investment banks do not add value to society, as your correspondent has been saying all along (Cassidy, “What Good Is Wall Street?” The New Yorker, Nov. 29, 2010).

What do these so-called bankers do? They trade for the banks’ own account. Noting that the big banks get most of their revenue from trading, Cassidy explained:

In effect, many of the big banks have turned themselves from businesses whose profits rose and fell with the capital-raising needs of their clients into immense trading houses whose fortunes depend on their ability to exploit day-to-day movements in the markets.

Yet Congress has just passed massive legislation that focuses on banks qua lenders, presumably to borrowers other than hedge funds, from which banks are difficult to distinguish (The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA), P.L. 111-203).

What else has happened since this book was published?

1. Spencer Bachus, who is about to become chairman of the House Financial Services Committee, said he thinks Washington and regulators should serve banks, not the other way around.

2. Credit default swap volume has fallen slightly. ICE Trust, the world’s largest derivatives clearing platform, has decided not to register with the CFTC as a derivatives clearing organization (The New York Times, Dec. 29, 2010, p. B4).


4. George Soros set up the Institute for New Economic Thinking to rescue economic theory from failed free market dogma.

5. The Commodity Futures Trading Commission proposed rules for derivatives clearing organizations covering conflicts of interest and requests for approval of marging practices, while backing off proposed rules for commodities position limits.

6. The CFTC backed off on a proposed rule that would have set generous position limits on speculation in commodities contracts for physical delivery.  

7. ProPublica exposed how Merrill Lynch traders blew up their own firm by paying themselves bonuses after causing it to buy dodgy collateralized debt obligations it had underwritten (http://www.propublica.org/article/the-subsidy-how-merrill-lynch-traders-helped-blow-up-their-own-firm).

8. Republican members of the Financial Crisis Inquiry Commission, many of whom did not attend meetings, issued their own fictional account of the meltdown, which did not use the words “derivative” or “deregulation,” but instead blamed it all on Fannie Mae.

9. Peter Orszag went to work for Citigroup, the zombie bank that has been kept alive by the U.S. government on more than one occasion.

Readers who want the unvarnished version of what went wrong should get Barry Ritholtz’s Bailout Nation: How Greed and Easy Money Corrupted Wall Street (Wiley 2009) or R. Christopher Whalen’s Inflated: How Money and Debt Built the American Dream (2010). Or if there’s no time to read, see Charles Ferguson’s documentary Inside Job.

Readers should read Regulating Wall Street to understand why, in the face of market failures and copious evidence that Wall Street is unproductive,
Congress and regulators labored mightily to resurrect the financial intermediation racket just as it existed on September 12, 2008. Wanting to put Humpty Dumpty together again was, as your correspondent has repeatedly argued, the central mistake of the DFA (Tax Notes, Aug. 23, 2010, p. 803, Doc 2010-18354, 2010 TNT 162-1).

The authors of Regulating Wall Street are very bright people. They are New York University Stern School of Business finance and economics professors who advised Congress on the DFA. They are, however, captives of free market ideology.

Regulating Wall Street begins inauspiciously with a forward by Myron Scholes — the very guy whose hedge fund, Long Term Capital Management, melted down almost 10 years to the day before Lehman Brothers collapsed. This should have served as a warning that deregulation produced the meltdown. The authors advocate a modified laissez-faire approach to regulation. Readers, no financial intermediary in the United States — or the world, for that matter — is in any imminent danger of being overregulated.

But the authors acknowledged that there is a strong economic case for reinstatement of Glass-Steagall functional separation. They support the Volcker rule as originally proposed, and regard the enacted version as a small step in the right direction.

The book is loaded with valuable information about what went wrong. It’s the conclusions that are often dangerous. The authors believe in “natural” and “organic” regulation by means of market mechanisms. Market mechanisms failed because risk was underpriced. Risk was underpriced in part because tail risk was unknowable.

Moreover, markets did not have sufficient information to function. Fraud and criminal behavior caused information to be withheld from investors. The book contains barely a mention of the largest banks and hedge funds’ participation in securitizing bad mortgages made by mortgage mills. (For a roundup of investigations, see http://www.propublica.org/blog/item/the-year-in-wall-street-investigations.)

We believe in real regulation — telling financial players operating with implicit government guarantees not to do some things. No financial product that cannot be adequately margined because risk cannot be measured should be permitted to be sold, unless there is overwhelming social need for it, like property and casualty insurance. Social need would be gauged according to the needs of the general population, not bankers and their plutonomy.

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But you gotta love academics who are willing to use words like “dodgy” and “dubious.” Each chapter of Regulating Wall Street stands on its own, so readers can pick and choose topics like systemic risk and resolution authority. The last chapter, which is woefully brief, discusses the role of financial accounting — about which an entire book could be written.
Pigouvian Tax

The authors have one very constructive suggestion: Tax the institutions that pose the greatest systemic risk. They expect miraculous behavioral changes from taxation, but taxing these monsters is still not a bad idea, because they will inevitably be bailed out with general revenues.

The authors recognize that, contrary to the Treasury secretary’s professed belief, the Basel III capital standards will not be sufficient to mitigate systemic risk. But they would allow the giant banks to stay gigantic, with fingers in every financial pie, on the view that modern global financial markets demand bigness and the increased systemic risk can be contained by tailored taxation.

Trouble is that the too-big-to-fail banks are too large and complex to be effectively regulated. The six largest American banks list about $9 trillion of assets, which represents 55 percent of all assets in the banking system. Four of them are the largest derivatives dealers. One of them, Citibank, is shrinking, because the government controlled it.

Oh, but don’t they need to be huge to compete with European universal banks? The universal model has not worked there either. European banks are far bigger in proportion to their home economies than the largest American ones. Many of them are also insolvent, and papering over this state of affairs is what the sovereign debt crisis is about.

The authors view their proposed Pigouvian tax as an extension of market mechanisms. They want to use a tax mechanism as an insurance premium charge to prod banks into holding more capital against systemic risks that they cause but would otherwise not take into account. They want the banks to internalize the negative externalities they impose on the system. Then the banks would decide for themselves how risky they wanted to be. How’s that again?

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The tax would be customized for each bank based on its expected loss in equity value on a one-day market crash, plus the bank’s proportionate share of systemic costs that would be incurred in a crisis. The point is to devise a tax to charge each big financial player for the cost of the government guarantees it enjoys. Banks would thereby be induced to restrict their risky activities.

“The firms will organically dismantle themselves to become institutions with the appropriate size, leverage level, and risk profile,” the authors maintain. “It is highly likely that this approach would greatly reduce the likelihood of a crisis and reduce the too-big-to-fail mantra.” They are correct that the DFA merely tries to manage risk and may well end up not reducing it.

How does one derive any of the three factors in the authors’ tax formula? The authors base the bank’s expected losses on how much its share price can be expected to decline in a day if the whole market declines by 2 percent. This shows a touching and misplaced faith in the equity markets. Yes, the equity markets do know when banks are shaky, but they still attach an option value to basket cases.

When a share price goes below $5, a share is effectively an option. Citigroup, at $4.77 at the time of this writing, is an option. Five years ago it was $50 per share, and even just before the meltdown people were still paying $25 a share. Moreover, share prices don’t reach the bottom in one day, so why would a one-day measure be appropriate? If there is a correct price, it can take a while to discover it.

How are government-goosed prices valid market prices? The stress tests were phony exercises to tell the markets that the government would stand behind the largest banks. The criteria used are there for anyone to read. And then the generous calculations of required new capital made according to these wimpy criteria were further reduced when the insolvent banks were allowed to argue they needed less. Share prices shot up once investors decided the government would backstop the basket cases.

The authors believe they can price systemic risk. But they acknowledge that it might be better to have a set regulatory tax for systemic risk, rather than relying on market-based discovery to price the equivalent necessary insurance premium. The calculation of the systemic risk costs would use a time series taking into account leverage, volatility, bubbles, the cost of past crises, and probabilities. The bank regulators would want to set the levy so that it would be countercyclical.

So even assuming the NYU computers can figure out how much a big bank’s share price would fall in a day, and how much the next collapse is going to cost, what would be that bank’s share of the tab? Well, the authors figure out that Citi accounted for 13 to 14 percent of the total loss of bank capital in the recent unpleasantness. (See http://www.vlab.stern.nyu.edu/welcome/risk.)

Citi would face a large tax bill for having made itself so vulnerable. What would happen when regulators inevitably stepped in and protested that
Citi is a worldwide payments processor (an essential utility function) that needs to be propped up no matter how foolish its management was about creating toxic mortgage-backed securities and keeping them on its books? The authors don’t factor in regulatory forbearance and favoritism, which loomed large in the bailout.

The DFA gives the government vast data-gathering authorization, and the authors want more. They point to the shocking level of interconnectedness that surprised regulators during the meltdown. Armed with NYU computers that can measure market risk, they ask for more tests of interconnectedness.

Most of the derivative contracts that blew up were between banks that were among the 19 stress-tested banks. If regulators could have identified these connections, the risk-inducing contracts could have been nullified with little cost to society. Instead they were paid off at 100 cents on the dollar, at great cost to the rest of the economy. If regulators could figure out all this systemic risk, they could prevent it outright instead of messing around with taxes.

Even if it could be calculated by regulators, the authors’ Pigouvian tax fails the basic tests for tax statutes. Tax statutes are supposed to have clarity and certainty. Tax liabilities are supposed to be readily calculable by the taxpayer and its tax advisers. The authors’ Pigouvian tax would be none of those things.

We have unnecessarily complex tax laws, but we don’t have bespoke tax rules. Yes, the largest taxpayers, who are under continuous audit, negotiate their tax liabilities as a practical matter, but there are no special per-taxpayer rules. Transfer pricing shows what happens when the tax negotiation is not anchored by a clear framework of rules. Like that mess, the authors’ Pigouvian tax would provide gainful employment for another generation of economists.

Taxes are supposed to be horizontally equitable, in that similarly situated taxpayers bear similar liabilities. The authors’ customized bank tax would see banks of similar size getting different tax bills. That, of course, is the point, but that is not how taxation is supposed to work. The tax system passes judgment only on the behavior of individuals.

Readers will recall that the Obama administration proposed a financial crisis recovery fee on the largest banks as part of its statutory responsibility to recoup TARP costs. (For analysis, see Tax Notes, Feb. 1, 2010, p. 561, Doc 2010-1962, or 2010 TNT 20-2.)

The fee would be imposed on the worldwide consolidated liabilities of the largest financial institutions, regardless of type of charter. The base would be measured by liabilities shown on the regulatory balance sheet. For banks, the covered liabilities would be defined as the result of total assets minus Tier 1 regulatory capital and deposits insured by the FDIC.

Compared with the customized levy proposed by the authors, the Obama proposal has the virtue of relative simplicity. Liabilities are difficult to measure, as accounting regulators well know. Because the point of the fee is to discourage reliance on short-term funding, drafting would have to ensure that liabilities like repos, which comprise as much as half of short-term funding, are included.

The United Kingdom has enacted a bank tax of 0.05 percent of liabilities, net of deposits and liabilities collateralized by sovereign debt, like repos (Doc 2010-22842). Hungary has enacted a bank tax of 0.5 percent of assets shown on the balance sheets, causing the IMF to throw a hissy fit and withhold part of a loan (Doc 2010-16353). Yes, these taxes are blunt instruments that offend the tender sensibilities of economists, but both have the straightforward goal of revenue collection.

The Obama proposal and the authors’ proposal attack opposite ends of the maturity spectrum faced by banks — the authors want to charge for long-term exposure, while the Obama administration focused on short funding. Short-term funding is easier to measure, so the president’s proposal would be easier to administer.

Maturity transformation — borrowing short term to lend long term — is essentially what banks do. Maturity transformation is part of their utility function, for which they have always had an implicit government guarantee. Indeed, Wall Street also has always enjoyed an implicit government guarantee, if for no other reason than the number of its leaders running Treasury.

But in simpler times, demand deposits, which tended to stay put, were the source of short-term funding. Now it’s repos, commercial paper, bank obligations, structured instruments, and other impatient sources that can vanish overnight. A bank’s long-term exposures used to be loans to businesses and real estate, which had finite, predictable exposures. The modern long-term exposure is a credit derivative (which exists for speculation) featuring imbedded debt and an unpredictable tail risk. The combination of impatient funding and tail risk proved to be toxic.

The British and Hungarians have it right. Find a balance sheet figure that is readily ascertainable and charge a tiny percentage of it as a tax. Since the inevitable bailout will come out of general revenue, any contribution banks can be induced to make to that future cost is a well-designed tax.
Insurance Model

Perhaps the Pigouvian tax the authors want should not be dubbed a tax, but rather an insurance premium. The authors suggest a combination of public and private insurance to access private price discovery mechanisms. Insurance premiums would be credited against bank taxes. The coinsurance payout would go to the government in the event of bank losses. The government would act as reinsurer.

It would be based on the same principle on which FDIC premiums are based. But FDIC premiums have been shown to be politicized, pro-cyclical, and deficient in amount; the FDIC’s fund is depleted. The DFA strives to correct these problems by basing the FDIC insurance charge on a bank’s total liabilities net of tangible equity. The authors note that the FDIC rejected a private pricing model for its insurance.

Where does the authors’ faith in the private insurance model come from? Where is the evidence that we have gotten any better at identifying and pricing tail risk than we were two years ago? Why do the authors think insurance is any better capitalized or managed than fractional reserve banking?

The dirty secret of insurance and reinsurance is that insurers can’t price tail risk, either.

One would think that risk underpricing on the part of the undercapitalized and insolvent monolines, as well as AIG, would amply illustrate the inadequacy of the private model. When they get hit by claims from a big cataclysmic event, insurers just don’t pay (Lloyd’s, which would insure anything and whose investors had unlimited liability, blew up). An insurance policy is a document that gives the holder the right to sue the insurance company in court.

Moreover, insurance companies are undercapitalized, because they bought a lot of the garbage the investment banks were selling in the process of moving risk from players who did not want to bear it to investors who did not know they were absorbing it. Since 2008 insurers have successfully lobbied state regulators to permit them not to mark down all their derivatives and mortgage-backed securities. As the meltdown has demonstrated, being in compliance with regulatory standards is not a guarantee of adequate capitalization.

Animal Spirits

Acknowledging the difficulty of predicting the next crisis and measuring systemic risk, the authors suggest that, in addition to their Pigouvian tax, enhanced capital requirements and Glass-Steagall-like restrictions on activities might make sense.

Around here, we think that some activities ought to be prevented, not just measured, and all the measurement in the world will not stop risky behavior if the government stands behind the players. There is no chapter on bankruptcy, but along the way in Regulating Wall Street, the authors develop ample evidence that repos and derivatives never should have been exempted from the automatic stay. Or how about limiting repo collateral to government securities?

The authors recognize that enhanced capital requirements cannot solve all the problems. They conclude that contingent capital alone will not solve the problem of unidentifiable tail risk. Contingent capital would not take the punch bowl away in good times, when banks make bets that carry tail risk.

Moreover, the authors explain, contingent capital would not force conversion of intermediate levels of bank debt, including underpriced obligations on repo and derivative contracts. They wisely advocate limits on leverage ratios, which the DFA contemplates, noting that a slight chill can wipe out the equity of a highly leveraged bank.

The problem of contingent capital goes beyond the measurement issue. Triggering is unlikely. By the time the trigger level is reached, the bank’s short-term funding is likely to have disappeared. The authors acknowledge that the bank may become effectively insolvent even before the trigger is reached. This is the psychological dimension of illiquidity — the flip side of Lord Keynes’ animal spirits.

The insolvency or perceived inability to satisfy short-term debts of even a little player can sow panic. Penn Square was a little bank that took down Continental Bank. When it failed, Lehman Brothers was not all that big, and it was adequately capitalized according to applicable rules at the time. But its overnight funding was cut off. It was not rescued because the big boys had already stopped dealing with it.

Leaving aside the preservation of the existing system, the big problem with the DFA is that it focuses on regulation of the banking sector while basically ignoring the equally large shadow banking sector, except for pestering the players for information. The authors repeatedly note that the stricter the bank regulation, the more likely that dangerous activities will migrate to the unregulated shadow banking sector.

Yet instead of advocating greater regulation of hedge funds, they ask for even less, unless a hedge fund has been tagged as systemically important, in which case it would come under that special DFA regime. The authors believe that hedge funds provide liquidity and that they did not cause or contribute to the financial meltdown. Nonsense. By blaming the meltdown on the behavior of money
center banks, the authors ignore the symbiotic relationship between banks and hedge funds and the degree to which banks were acting like hedge funds themselves.

The collapse of Long Term Capital Management? A mere “externality” that the market seems to have solved because leverage levels are not as high. Predictably, the authors resist the EU investment funds directive and fret that some forms of mild regulation could damage investor confidence in collective investment vehicles. (For coverage, see Doc 2010-24277.)

The Most Dangerous Activity
Let’s get back to Jamie Dimon. Somehow we can’t imagine him writing a shareholder letter saying that JP Morgan Chase is organically dismantling itself to become right sized. Dimon is the guy who testified to Congress that the financial system would just blow up of its own accord every 5 to 10 years, the implication being that taxpayers would have to pick up the tab.

Dimon may be the most dangerous banker on earth at the moment, because he admittedly wants his too-big-to-fail bank to get even bigger. He apparently wants his bank to be internationally too big to fail, like Fortis, which was too big for three European governments when it went down.

JP Morgan’s derivatives operation is many times the size of the bank’s $2 trillion of assets, yet the Sunday magazine article barely mentions it. Credit default swaps were invented at the JP Morgan investment bank, and the SEC is investigating whether it allowed Chicago hedge fund Magnetar to pack a Morgan-issued collateralized debt obligation squared with garbage to bet against (http://www.propublica.org/article/sec-investigating-deal-between-jpmorgan-and-hedge-fund-magnetar).

Yet all we are told is that Dimon became educated in derivatives and thought they were risky. When Bear Sterns went down, JP Morgan was its largest counterparty. JP Morgan did not “rescue” it as the Sunday magazine article says, nor, as the article implies, did it act out of altruism. The Fed took Bear’s bad assets, and JP Morgan was allowed to buy the entire Bear operation for the price of Bear’s midtown building. That operation included a valuable prime brokerage. (For analysis, see Tax Notes, Apr. 7, 2008, p. 19, Doc 2008-7372, or 2008 TNT 68-12.)

The authors of Regulating Wall Street like credit default swaps as a pricing mechanism. They recognize that requiring adequate collateral would kill the product, so they change the subject, advocating disclosure instead.

Oh, but the DFA mandates clearing of derivatives, doesn’t it? Won’t that make everyone safe from them? The authors hope that private clearing initiatives will ultimately provide safe margining and transparency, but things are not looking that way.

The authors of Regulating Wall Street like credit default swaps as a pricing mechanism.

The DFA does not create any public derivatives clearinghouses. Existing private clearinghouses operate as clubs for their big dealer members. The largest of these, ICE Trust, clears credit default swaps. Organized in a tax haven with $9 billion in capital, it clears $6 trillion of notional contracts annually. ICE Trust decided against submitting to CFTC registration, but it nonetheless will be grandfathered as a derivatives clearing organization under the DFA. (See https://www.theice.com/publicdocs/clear_us/ICE_Trust_Overview.pdf.)

The authors’ faith in markets does not prevent them from observing that clearinghouses can concentrate systemic risk, making them too big to fail, that some have failed, and that some contracts are not amenable to market pricing and trading. The failure of one big member can threaten the existence of a clearinghouse. When the Chicago Mercantile Exchange was on the ropes, Continental Bank was called in to rescue it. Two decades later, Lehman’s failure nearly took the Merc down again.

The authors hopefully point out that clearinghouses have failed less often than banks. But they would have to be rescued with taxpayer funds when they do, despite the DFA’s superficial prohibition. As a practical matter, any private derivatives clearinghouse that is big enough will have to be bailed out by the government.

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