# On the reform of the financial system

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## Sheme of the work

- 1 legislative changes in financial regulation in the U.S.A.
- 2 debate over financial regulation in theory
- 3 what should be done: some questions arising from Minsky's thought.

## Dodd-Frank Act

- Main points:
- Volcker rule
- Derivatives regulation and central clearing
- The role of the Fed

## kregel

- At this point it is not possible to go back to Glass Steagall, Kregel argues, unless a way back from securitized lending to old style lending is planned and implemented. In fact, the traditional way of making loans has been replaced by securitization and because of this, it is no more possible to make loans without being allowed to trade in securities. Clearly, banks, if they have to lend, cannot be forbidden to trade in securities.

## kregel

He acknowledges however that this is only a partial solution given the complexity of the financial system. The biggest part of deposits are held now outside the banking system in its proper meaning.

*He suggested another possible solution in the long run, which tends to separate the deposit making activity of banks from their deposit taking activity.* The state should warrant transactions accounts, safe by definition, and directly warranted by the state without any type of intermediation such as the FDIC, Federal Deposit Insurance Corporation.

The deposit making activity of banks, which consists in making loans and thus accrediting deposits to the borrowers, should be left to the market, to investment banks and other private financial institutions, which, however, do not hold on the liabilities side of their balance sheets deposits, which are equivalent to cash.

Wray (2010) argues that the state should warrant access to central bank liquidity and lender of last resort facilities to both deposit taking institutions and lending institutions. The state should however create a favourable environment by means of incentives and regulation to small banks and institutions that make loans to small communities projects. It should favour the profitability of these institutions versus big banks and non banks. In particular the banks should start again to do their job that is lending and underwriting.

Solvency protection should be warranted only to the institutions which fulfil a public function. Those institutions, which have investment strategies which run counter to public interest should, of course, not be warranted protection against default. In particular, following the development of Minsky's thought on the subject, Wray (2010) concludes that banks should be prevented from using insured deposits in a manner that causes the capital development to be ill done.

## Shadow banking system

- To address the issue of the shadow banking system and the danger that its investment strategy poses to the stability and soundness of the whole financial system, Wray proposes an idea put forward by H.Minsky in his later works, namely that competition to the pension funds, which enjoy government's protection (tax treatment and insurance) be created. He suggests to introduce other types of savings for retirement such as open ended accounts. The managers of the pension funds are, according to some studies, responsible for the speculation on commodities in the 2000s.

## Regulation and shadow banking system

- H.Minsky (1982) wrote the central bank must be a lender of last resort to the whole financial system not only to banks.
- How it is possible to apply this in the present conditions?
- During the crisis this has happened.
- Now the shadow banking system is going back in the shadows.

## Temporary facilities

- Temporary facilities measures that have extended last of resort facilities to the whole financial system are being retired.
- The reason is quite evident: they were thought to be temporary.
- Are they going to be resumed whenever a crisis occurs? The answer seems to be yes.

## What will happen after the unwinding of temporary measures?

The central bank cannot replace forever markets, which are considered extremely risky, such as that for mortgage backed securities and all types of commercial paper and for which there are no more private issuers. Those markets must be reformed in order to offer warranties to the issuers and to the investors.

## criterion

A reasonable criterion would be to warrant such goods only to institutions which do not engage in systemic stability endangering transactions. Most of the activities, which were left to the market, like insurance through derivative products were largely unnecessary and inefficient. The whole invention of credit default swaps and the like as a replacement for state insurance to the liabilities of shadow banks does not make any economic sense.

## CDS

CDS are financial instruments that cannot provide any insurance against systemic events and this holds independently of the fact that they are cleared through clearing houses or not. Clearing houses themselves may need to be rescued with public money.

## Cds and bankruptcy law

Moreover, derivatives products still enjoy a special treatment in the US bankruptcy code. Chapter 11 foresees that bankrupt firms are prohibited from repaying their debtors immediately so that they may try to reorganize their business without immediately closing. This does not hold for debts and claims linked to derivatives transactions. The debtors in these transactions are free to "jump to the head of the bankruptcy repayment line" (see Roe 2010).

## CDS

- This contractual advantage in turn will encourage new entrants into this market, which has experienced after the crisis an increase in the volume of transactions. This will add to the systemic fragility of the system. For example, in the case of Aig, debts linked to credit default swaps were immediately paid with public money.

## Structural measures tending to downsize the financial system needed

- Further measures tending to limit the entry into the regulated part of the shadow banking system should be introduced. Establishing a charter to do certain activities should impose a limit to entry and a selection of perspective entrants. The number of shadow financial institutions has greatly increased because of the high rate of profit gained in this industry at the expense of the citizens.
- In a way the opposite should be undertaken as to banks and non banks. The entry into the non bank financial institutions sector should be made more difficult, while a large number of small community type banks should be favoured.

## Monetary policy

- A low but positive interest margin (in real terms) is needed if banks and other financial institutions must make a profit from lending. A monetary policy that aims only at flattening the yield curve will favour the institutions that speculate on future price rises of the assets.

## Restructuring of the financial system

The restructuring of the financial system should contain:

- Intervention which deal with the mortgages that will not presumably be paid in the future;
- Reform of securitization;
- Banning of derivatives transactions that are damaging financial stability such as credit default swaps.

## Shadow banking system

- More generally it should be preserved and regulated that part of the shadow banking system that fulfils some needs not really satisfied by the banks. It should be prohibited or simply discouraged that part whose aim is just to increase through reciprocal debts and credits the return on equity of financial institutions.

## Quantitative easing

To that extent I do not think that a quantitative easing policy that is flooding the market with money would serve that scope. If a reasonable profit margin for banks that lend to customers must be created interest rates must be low but positive in real term. A terribly flat yield curve forever would not help in this. Rather it would encourage all types of institutions to try to get higher profits through asset inflation again.

## To hinder the funding of the shadow banking system

- *Moreover if a dismantling of the worst part of the shadow banking system must happen, the easier way to do it is just to hinder the funding of this system.* This funding is made by institutional investors like pension funds (see Poszar et al. 2010).

## Supply of safe medium term bonds with low but positive return

Prohibiting pension funds and other institutional investors from purchasing the assets issued by those entities would be a big step forward. On the other hand it is reasonable to satisfy the appetite of investors for safe medium term assets with a positive return for pensions and other reasons. The supply for them could be provided by the financing of public investment through long term bonds ensured by the state with low but positive return.