



Policy Incompetence

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President Obama announced today that he wants to prevent banks from engaging in proprietary trading activities, private equity transactions, and hedge fund activities. In effect, he wants risk taking separated completely from banking. He also wants to limit the size of financial institutions. His objective is to prevent banks from engaging in risky activities to prevent any reoccurrence of the credit crisis that damaged the financial system and contributed to a severe recession. While the objective is laudable and the financial system is in need of new regulations to protect it more effectively, the proposed approach is naïve, is likely to be ineffective, fails to reflect what actually happened, is unlikely to be implemented as proposed, panders to the financially unsophisticated public, and will contribute to more turmoil in the markets for its populism and ineffectiveness.

The proposals fail to understand how the financial system went into crisis. Neither Fannie Mae nor Freddie Mac is a bank. Bear Stearns and Lehman were not banks. AIG was not a bank. J.P. Morgan Chase is a bank that engages in proprietary trading and banking and it was not damaged by the crisis. Countrywide engaged in some proprietary trading activities that Obama would not now permit, but those trading activities had nothing to do with the enormous damage that firm inflicted on the financial system by making large numbers of poorly documented sub-prime loans to people who could not afford the homes being purchased or refinanced. New Century engaged in no proprietary trading activities and was not a bank, yet that did not prevent it from making fraudulent or inappropriate sub-prime loans. Washington Mutual was a bank uninvolved in prop trading, yet blew up because of poor mortgage underwriting. CIT's bank was uninvolved in its entry into activities that incurred huge losses and forced its restructuring. Hartford Insurance nearly collapsed, but it engaged in no banking activities. I could keep going.

The idea of separating risk taking trading operations from banking is also hard to understand. Banks make loans, such as mortgage loans. If they are not permitted to trade these mortgages, they must hold them until maturity. This has one nice benefit in that a bank would surely be more careful about its lending if it must own the loan. But, such a rule also destroys the ability of the bank to get liquidity if the bank needs it. If the objective is to have the bank retain exposure to the loan so that it will underwrite more carefully, then this can be readily accomplished by setting a minimum retention rate on any underwritten loans, so the bank can sell off the remainder.

The President's proposal would preclude any bank from owning a hedge fund or prop trading activity. How would such a rule be applied to a foreign bank, such as Deutsche Bank, UBS, or Barclays? It is highly doubtful our rules could be applied to such firms. What would prevent any U.S. bank from setting up its trading activity offshore? All our largest banks already have such trading operations in the world's premier financial markets, including London and Tokyo. They typically even have such operations in secondary financial centers, including Singapore, Hong Kong, Paris, Frankfurt, Toronto, and elsewhere. U.S. hedge funds may trade with the operations





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in New York, but they typically also trade with the U.S. bank's trading desks located in these other financial centers. So, it is doubtful any such rules could be applied even to our own firms. It is a safe bet all these points will be made by bank lobbyists. The government might blame the lobbyists for obstructing approval for his proposals, but these proposals are likely to fail because financially sophisticated individuals understand how totally irrelevant and inappropriate these proposals would be.

The President would preclude any firm from proprietary trading and running a bank. Goldman Sachs would easily circumvent this proposal by giving up its bank charter, a charter it took on only after the crisis broke. In fact, that charter gave the Federal Reserve a channel through which it could have extended credit to Goldman. One of the claims that was made by Bernanke and Paulson was they could not extend credit to Lehman because it was not a bank! So, they had no choice but to allow it to fail! Looking back, one of the most serious mistakes made during the crisis was Henry Paulson's decision to allow Lehman to fail, which rippled through the financial system and provoked the meltdown of the markets.

Government actions unquestionably worsened the credit crisis and a case can be made that the actions of the government instigated the crisis. Government actions failed to prevent risky activity even when bank regulators and supervisors were aware of that activity. Fannie Mae and Freddie Mac were both compelled by legislations to make risky mortgage loans low income borrowers. (Barney Frank publicly threatened them for not making enough such loans.) When Paulson took over Fannie and Freddie, he immediately suspended the dividends on their preferred shares, which severely impaired many banks that owned such preferred in their portfolios on the recommendation of the Office of the Comptroller of the Currency! Several banks were destroyed as a result. But this action also rendered it impossible for other banks to raise fresh capital by issuing preferred shares, since investors were afraid to buy such stock after seeing what Treasury had done to the Fannie and Freddie preferred shares. And as mentioned, the handling of Lehman was a total disgrace that precipitated a collapse in many financial markets. It led directly to losses at The Reserve money fund, which triggered a run against all money funds, as just one example.

The President declared that a few large firms will not be permitted to run the financial system. Will the British break up Barclay's? Will the Japanese break up Bank of Tokyo Mitsubishi? Will the French break up BNP Paribas? Will the Germans break up Deutsche Bank? Good luck. So, do we really want to turn our top tier banks into pygmies to compete against these formidable foreign institutions?

President Obama's proposals suggest that the Federal government is engaging in blaming the banks for the financial crisis to divert attention from its own role, as well as divert attention from other issues. The proposals are unlikely to pass as proposed, since they are such bad policy it is hard to understand how objective individuals would approve such folly if given the time to understand what is on the table. Should some version of the President's proposals actually pass, and only this proposal passes, very little will have been accomplished in preventing a future financial crisis and the financial system will get around the proposals quite easily.

So, what should be done? First, government regulators and supervisors must become significantly more effective.



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If a firm is engaged in risky activity, regulators must halt that activity before it becomes large enough to sink the organization. This requires a significant upgrade in the quality of people who engage in such activity, much better compensation to attract such people, a focus by such people on risk taking and not on just mindlessly checking boxes to confirm that regulations have been adhered to. And, the people at these agencies must be held responsible for their failures. So, inappropriate behavior should be prosecuted. Few have been so far, even though the failings of the system began to appear in March 2007.

Second, government agencies need to be combined into efficient regulatory bodies that are aligned with the firms being regulated. Instead, agency heads have been jockeying to preserve their own turf and responsibility and Congress appears to have backed off from what needs to be done.

Third, capital requirements need to be aligned with risk taking activities. Firms that engage in prop trading need to hold more capital than firms that don't engage in such activity. Note, this recommendation will not be applied very easily to firms with international operations unless other nations implement the identical capital requirements. This has been done in the past, so it should not be a major hurdle.

Fourth, politicians need to stop pandering to the masses and manage the technical details associated with a complex financial system. Populist pandering to the masses hurts, as well demonstrated by today's selloff in the market. In fact, very, very few firms would actually be affected by Obama's proposals. Firms like Goldman and Morgan Stanley could simply drop their bank charters and continue with business as usual. Regional banks that have no prop trading activities, which is almost all of them, would find the new rules irrelevant to them. J.P. Morgan Chase, Citigroup and Bank of America would be most adversely affected, but would simply relocate certain activities offshore. So, why did the stock market sell off so sharply? Investors were appalled at the populism and inability of the government to manage the financial system. If this is the best they can do after all this time, how do we gain confidence that the government would do a better job of avoiding another financial crisis at some time in the future? The President's financial proposals qualify as an unmitigated disaster.