

Restoring Confidence in Financial Markets

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The loss of confidence triggered by the collapse of some of our largest financial institutions is perhaps the single most important factor holding us back from a healthy economic recovery. After the failure of Lehman Brothers, securities markets froze up and banks were no longer willing to lend. Instead, individual and institutional investors alike sought refuge in the safety of Treasury bills and accounts insured by the government.

As the financial markets froze up, the recession that was triggered by the bursting of the housing bubble instantly deepened and spread to other sectors of the economy like wildfire.

In the current crisis, almost the entire investment banking sector has been wiped out and the largest investment houses are now operating under a commercial banking charter.

The “Too Big To Fail” doctrine was put to the test not once, but several times by the threatened failure of our largest financial institutions.

The Federal Reserve as well as the government had to develop new and innovative techniques to deal with the financial problems threatening the health of the entire economy.

The same was true around the globe as financial turmoil and economic recession led to the first measured decline in world GDP since World War II.

While it is tempting to see the current crisis as a unique event in our life time because of the severity of the housing and stock market collapse, financial crises have occurred about once every decade since the founding of the Republic.

You all will remember the recession of the early 80's; the S&L and housing debacle of the early 90's; and the bursting of the internet bubble of 2001. We can also be sure that history will repeat itself.

Nevertheless, we should draw whatever conclusions we can from the current problems and try to build a stronger financial system for the future.

Restoring confidence in financial markets is clearly of the highest priority, because without a functioning financial transmission mechanism the real economy will not be able to recover and gather speed again.

At present, the US economy resembles a bicyclist who is pedaling furiously trying to make progress – while the financial services chain linking the pedals to the driving wheel is broken. Little of the impetus provided by the Federal Reserve and the government has reached the economy's driving wheels so far. While President Obama and Chairman Bernanke seem to be pedaling furiously, the economy is still at a stand-still.

If I were to be granted three wishes on what financial reforms should be implemented to restore confidence, what would they be?

I believe we should focus on building *safer banks, safer markets* and *a safer retirement system*.

In particular, let us remove much of the uncertainty now besetting the financial system. By restoring confidence we can bring true long-term investors back from the side lines so that their funds and investments will again propel the economy forward.

Safer Banks

The American banking system has undergone several transformations in recent decades. Shaped by the reforms enacted in the middle of the Great Depression, the U.S. banking system was highly insular and fragmented along *geographic* and *functional* lines. The McFadden Act of 1927 prohibited interstate branching and so the country's banking system was essentially composed of 50 separate banking systems. Furthermore, the Glass Steagall Act of 1933 separated commercial banking and investment banking.

This fragmented banking system made it impossible to diversify risk – which is absolutely essential to ensure safety.

Furthermore, with the increasing integration of the national and international economy, the need to serve banking clients in all parts of the country grew and hence national banking networks became an absolute necessity.

This realization resulted in the abolition of the interstate banking barriers (Riegel-Neal Interstate Banking Act of 1994) and the elimination of the repeal of the rules separating commercial and investment banking (Gramm-Leach-Bliley Act of 1999) in the Nineties.

The new 'universal banks' that are able to serve both commercial and investment clients helped fuel the economic boom of the 1990's and the early part of the 21st century.

I believe that the current economic crisis would have been much worse if these universal banks had not been in place when the housing slump of 2007 hit.

Just remember that during the last housing bust of the late Eighties and early Nineties over 1,000 banks and more than 1,500 S&L's failed – essentially wiping out the entire savings and loan industry. That is, a total of 2,500 financial institutions failed during that episode two decades ago.

Compare that to the current tally of about 50 bank failures so far. Things could have been even worse!

But at the same time, the investment banking industry has undergone a radical transformation. In the last two years, the six largest U.S. investment banks have either gone out of business, like Lehman Brothers; have merged into large commercial banks, like Bear Stearns and Merrill Lynch; or have converted their charters into bank holding companies, such as Goldman Sachs and Morgan Stanley did.

But in the process, we spawned a new phenomenon by the creation of the new nationwide banking behemoths: the “Too-Big-To-Fail” syndrome.

Which one is worse: having 2,500 financial institutions fail – as happened in the late 80' and early 90's *or* having all the large banks of the country on governmental life-support -- as is the case now?

Banking is not an inherently dangerous business. I have spent most of my life in banks and with bankers. Most of them are pretty conservative, dull and maybe even boring.

But every now and then, you find a young genius who exhibits flashes of brilliance and earns the bank large sums by daring speculative trades in the foreign exchange, futures or derivatives markets. After receiving bonuses in excess of \$ 5 million per year for several years in a row, one such trader was fired last year after he ran up a loss of about \$ 5 *billion* dollars last year. His string of luck had finally run out! But the bank was left holding the bag and had to absorb that enormous loss.

One of the key reasons for the sharp fluctuations in bank income these days are trading losses and gains. It is therefore proper to ask why banks engage in these activities.

Clearly, there is a legitimate reason for banks to engage in trading activities on behalf of their customers. They can earn a small, but secure profit on each transaction they execute on behalf of their client.

In these trading activities, banks earn a profit just like a real estate brokers earns a commission for bringing buyers and sellers together.

But banks sometimes also take speculative positions on behalf of the bank itself. With these positions, they put the banks own capital at risk. They often do so in a highly leveraged way. If the bet pays off, the bank makes a profit; if the trader loses the bet, the bank absorbs the loss.

This speculative position taking is akin to a real estate broker who buys a house in the hope that he or she can “flip” the property and sell it quickly to a buyer. But now, the broker has his own capital at risk and if he has borrowed to finance this transaction, he is highly leveraged and the chance of loosing all or most of his capital is vastly increased.

This is the same with bank traders who put the bank’s capital at risk by holding speculative positions in financial markets.

That’s why the stock of Bank of America plunged 24 percent last week (4/20/2009) when the bank announced vastly *improved* earnings of over \$ 4 billion for the first quarter. These earnings greatly exceeded the analysts’ expectations – but the earnings came from trading operations that investors saw as highly speculative and uncertain. Consequently, the stock got punished.

In essence, the traders were gambling with the shareholders capital – and they did not like it: if the trader’s bet pays off, he stands to gain a large

bonus. If the bet does not pay off, the bank's shareholders are on the hook. That scenario no longer plays well.

But because the government serves as the ultimate guarantor of the safety of the bank deposits through the FDIC, the regulators also have a profound interest in minimizing a bank's risk exposure.

Let me emphasize that I believe that re-erecting the Glass Steagall barrier separating commercial from investment banking would not be a good idea. Instead, fencing off the deposit-taking banking institution from the risk-taking activities of traders who like to place speculative bets that often amount to gambling would make more sense.

The result would be universal banks that can serve all the needs of their commercial and investment oriented customers.

As a consequence, there would probably emerge a different set of institutions that would cater to those who want to take speculative risks. This might combine the risk taking activities taken on nowadays by hedge funds with the proprietary trading activities of banks.

That is, deposit-taking institutions and risk-taking institutions would be separated from each other.

As Congress and the administration consider banking reform, they may well want to focus on this division and limit much more sharply the extent to which banks can take large risks by incurring speculative open positions in their trading operations.

Safer markets

Next, let me turn to the stock market.

The vast majority of all stocks are held by investors who are either individuals saving for their retirement as well as pension and trust funds that

have much the same purpose: namely to invest funds to achieve a prudent return for their investors. Many mutual funds also belong into this category.

Safety and a reasonable rate of return are the primary objectives of these investors.

There are very explicit rules that individuals and money managers have to observe in these IRA, SEP, Keogh, 401k and other retirement funds. Namely, they are bound by the so-called “prudent investor” rules that do *not permit short sales or purchases on margin*. Most derivative instruments are also off-limit.

The same is true for many institutions, such as pension funds, insurance companies, trust companies and other investors that are often required by law or charter to adhere to a “prudent man” standard.

That is, the majority of all participants in the stock market are long-term oriented investors that supply the capital for a thriving economy.

But enter hedge fund managers, program traders and other short-term traders that devise fancy mathematical trading models and short-selling strategies and the previously safe road to retirement takes on a much more dangerous dimension.

It is difficult to argue that these market operators increase the overall return earned by the corporations in which they invest. These traders just hope to explore small market inefficiencies and be a bit faster in buying and selling securities than the long-term investors. They will change investment

vehicles frequently, sometimes every few minutes or even seconds, and thereby hope to garner a significant slice of the available economic pie.

But does this help the long-term investor who is investing in the same stocks or bonds? I have a hard time in finding any evidence for that. Some argue that these traders increase liquidity in markets and that may well be true. But by engaging in large amounts of day-trading and quick in-and-out selling and buying, these short-term operators may also increase volatility and therefore uncertainty. By taking advantage of short-term profit opportunities, they attempt to take away part of the economic return that would otherwise accrue to the buy-and-hold long-term investor.

What is the solution?

I would like to propose a new set of trading rules that can be freely and voluntarily adopted by the corporations issuing these securities. If the New York Stock Exchange and the NASDAQ do not want to permit these new rules, we may want to start an entirely new market where all securities are traded under these rules – we may call it the “Prudent Investors Exchange” -- or PIE for short. Simple as apple pie.

Under these Prudent Investor Rules there will be no short sales and no purchases of securities on margin. Just plain vanilla stock and bond trades are allowed.

Mind you, these are essentially the same rules under which all IRA and Keogh investors are trading in their accounts right now! Similarly, pension and trust funds investing under the “prudent man” rules have to invest under these restrictions. Thus, there will be plenty of natural investors

who will be attracted to these securities and I would not expect a shortage of demand these types of products.

In addition, I would impose a minimum holding period of one week for these securities to eliminate the day-traders and to provide a level playing field and more security to the long-term investors who are not able to spend the entire day on their trading desks.

Would that be an onerous restriction? I very much doubt it. Again, in virtually all 401k retirement accounts that I know of you are not allowed to change your asset composition more than once a month. So that is nothing new.

Furthermore, most hedge funds do not allow you to buy or sell more than once a quarter – and sometimes even less frequently. And these are supposed to be the smartest market operators on the planet! Obviously, they know what is good for them.

All I say is: what is good for the goose is good for the gander, namely the average investor. Let's not tie the hands of the retirement investor just so that they are easy prey for the speculators. Let's establish a fair and level playing field with the same rules for all!

So, let me repeat the simple rules of the Prudent Investors Exchange: No short sales, no margin purchases, a one week holding period and the freedom for each corporation to list its securities to trade under these rules.

I already said that many securities in retirement accounts are already subject to these rules and so there will be a natural *demand* for these securities.

But would corporations want to have their securities listed on such an exchange or under such trading rules? In other words, will there be a *supply* of such instruments?

I presented this proposal recently to a group of about a dozen Chief Financial Officers of some of the largest corporations – you would recognize the names of almost all of them instantly. At the end of the presentation, I asked for a show of hands of who might be interested in listing his company's stock on such an exchange – and all hands went up. I was truly amazed!

I must admit, however, that no financial institutions, stock brokers or banks were represented among the CFO's around the table. Maybe the result would not have been so unanimous.

I would expect that corporations that want access to the funds of prudent individual investors, conservative mutual funds, pension funds and similar institutional investors that are bound by the "prudent man" rules to list on the PIE. Confidence would be boosted and investors would return to the markets so that corporations would again have access to the investment funds needed to restore growth and prosperity.

Clearly, these Prudent Investor Rules would not eliminate all fluctuations in the stock market. But events, such as the financial panic of last fall, when speculative short selling amounted to 70 percent of the entire

trading volume in some stocks -- and whose value plunged consequently by 50 percent or more in a just few days -- would be a thing of the past.

Safe Retirements

Let me turn to my last proposal, which is designed to improve the safety and security of our retirement arrangements.

The recent drop in the stock market has decimated the individual retirement accounts on which many Americans now depend. Decades ago, most Americans retired with a *defined pension benefit* from their employer. That financial security was based on life-long employment by one company and the slow build-up of financial assets in that company's retirement account.

Since then, two changes in the economic and social environment have brought about a radical change in the security and confidence with which Americans approach retirement.

For one, companies faced with ever increasing pension obligations have shifted from *defined benefit plans* to *defined contribution plans*. Think of the enormous pension burden shouldered by companies like GM, Chrysler and Ford and you get the picture.

Second, most employees have become much more mobile, shifting between jobs every few years and consequently, many individuals have forfeited their retirement benefits because they did not reach the vesting threshold.

If you look at the average retiree without a sufficient company pension – and I think that represents the majority right now – you see a person who relies upon two financial resources for retirement. First of all, there is Social Security and second, there are the person's own savings. Social Security is basically a social safety net that provides a maximum benefit of \$ 2,323 per month for those retirees that have worked most of their life. Here in San Francisco, that may be just enough to pay the rent.

So, most people have to supplement their Social Security income by private savings. But how much is enough for that purpose? This is a most difficult question to answer. If you would ask five different financial advisors, you would probably get five very different answers.

First of all, you must know how *long you will live*. Clearly, you will need more money if you live until 80 than if you die at 70. But are you sure that you will not live until 90? And if you should live until 100, your earnings capacity is certainly not very great. I do not want to scare you, but the world record in that department is 122 years and 164 days and was set by a French lady. And while you may have no ambition to exceed that record, the lesson to be learned is that you have to accumulate enough money to last your entire lifetime – never mind how long that may be. And all the money left over will go to your close relatives and friends – unless the government taxes it first. And who wants to accumulate money for that purpose?

Second, you do not know the rate of return on that retirement money. If you invest in the stock or bond market, you may be unlucky if the market happens to turn sour and you lose 30 or 50 percent of your life-time savings in a few weeks. So, again, you have to over-save to guard against the

possibility of market fluctuations – and again your descendants or the tax man will be the main beneficiaries.

The way out of this dilemma may consist of a retirement arrangement that involves the following components:

First, all employees pay a certain percentage of their salary during their entire working life into a *common insurance fund*.

Second, the funds are invested in a prudent manner in a balanced portfolio of stocks, bonds, and inflation-protected Treasury securities.

Third, at retirement age the fund calculates a *life-time annuity* for the recipient which is then paid out in the form of an inflation-protected life-time annuity.

Such an arrangement would provide portable, life-time, inflation-protected income for all retirees and thereby enhance the confidence with which people can finance their retirement.

Again, I am not trying to re-invent the wheel here but merely advocate a general system similar to the University of California Retirement System or CalPERS which provides pensions for public employees like teachers, judges and legislators. In turn, the new retirement fund could place its investment in the stocks and bonds securities trading on the Prudent Investor Exchange that I have described earlier.

Conclusion

In closing, let me summarize the three main suggestions for restoring confidence in the financial sector:

First, let us take steps to sharply limit or even eliminate the capacity of depository institutions to take speculative trading positions;

Second, allow corporations to choose a set of rules under which their securities are traded, including a set of “Prudent Investor Rules” that will eliminate purchases on margin and short sales and that requires a minimum holding period of one week for these securities;

Third, let us work towards the establishment of a safe pension system that is based on portable contributions and that will pay secure life-time annuities.

I believe that these three steps will restore confidence in our financial system and bring investors back into our capital markets so that the current grid-lock in the financial system is broken and people can again invest with confidence in their future.

Thank you very much!