

Is Reform of the Regulation of the Financial System an Oxymoron?

Jan Kregel

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Three Stages of the Crisis and the Application of Existing Regulations

We can divide the current crisis into three distinct stages. Each stage had an associated discussion over required reforms of the regulation of the financial system. After the increase in defaults and the reversal of house prices in 2006 led to the insolvency of several large mortgage originators such as New Century and Countrywide in the Spring of 2007, attention was focused on the regulations governing mortgage lending. This was the stage in which the problem was considered to have been “contained”. Despite discussions of fraudulent lending and measures to rescue borrowers little as done in either respect. Losses were contained in the sense that they were primarily absorbed by the households who could no longer meet their payments on non-traditional mortgages. Although the bankruptcy judge dealing with New Century recommended that management be tried for fraud and required to repay bonuses that have been paid against fictitious profits generated by inaccurate and probably fraudulent bookkeeping practices, as of today this has not occurred. The Fed eventually moved, not rapidly, to amend Regulation Z (Truth in Lending) under the Home Ownership and Equity Protection Act (HOEPA) in July of 2008.

But long before the Fed had moved to act the impact of mortgages defaults reduced the value of the securitized assets that had been originated by banks and caused balance sheet losses attention passed to the role of contingent liquidity guarantees, credit default swaps and other over-the-counter derivative contracts in their creation in the process of loan securitisation. Attention was now shifted to the appropriateness of existing capital adequacy requirements and the revision of the as yet to be fully introduced Basel II capital requirements. The Basel Committee is still at work on these revisions. Banks moved to raise additional capital and once again the problems were considered to have been contained by the Feds move to rescue Bear Stearns via a pass through loan from JP MorganChase, a facility that was eventually extended to all US government securities dealers.

Finally, in September of 2008 the collapse of Lehman Brothers mortgage and real estate units produced a complete collapse of short-term money markets, including money market mutual funds. This time the problem was considered to be liquidity, not capitalization, and the response was a full FDIC guarantee of virtually all short-term liabilities of financial institutions in the system and opening the discount window to all private sector business and to virtually all assets as collateral. The Fed allowed its balance sheet to balloon to absorb the private sector assets that the private sector was not willing to hold. As Richard Kahn pointed out long ago, it is the role of the banking system to hold the assets that the public chooses not to hold, as it is the role of the Central Bank to hold the assets that the private financial system chooses not to hold.

The difficulty with this approach is that it is always reacting to a failure of the existing system and attempts to provide a change in regulation to return the previous system to its functionality. If the problem was regulating sub prime, then introduce regulation of sub prime and the system will be fine; if the problem was the way capital adequacy was calculated, revise the capital adequacy regulations and then everything will return to normal; if the problem is insufficiency liquidity provision, introduce more stringent liquidity requirements and the system will again return to normal functioning. But, as seen in the period from the introduction of GLB, the system has never returned to normal. Indeed, it is the normal that is the problem. Proceeding by simply repairing, there will never be significant reregulation of the system.

As Minsky has emphasized since his earliest work on financial market regulation, it is impossible to provide regulations to increase the stability of financial markets if you do not have a theory of financial market instability. If the normal precludes instability, except as a random ad hoc event, regulation will always be dealing with ad hoc events that once they have occurred are unlikely to occur again, and thus the regulations are powerless to prevent future instability. Instead, Minsky argued that what was required was a theory in which financial instability was a normal occurrence, and only on the basis of that theory could regulation be designed and understood.

Let us then look first at the three regulatory stages of current crisis, the way in which they were evaluated and the solutions proposed. As noted, the conclusion is that there has been virtually no real change in regulation of the system, and indeed, that it is inherently impossible to do so on the basis of the existing normal model of the financial system.

Yet, there has been radical reregulation of the US financial system, in particular in the National Bank Act of 1864 and then in the Banking Act of 1933. How did these two experiences differ from the present? What allowed then to introduce real regulatory change and why are these conditions no longer present?

Regulation and Supervision of Mortgage Lending: Unregulated Mortgage Affiliates

While it has been argued that such lending had been subject to lax regulation, this is not precisely true. More correct would be to say that existing regulations were not applied and that supervision was lax by design rather than by oversight.

According to the Mortgage Brokers Association, "Mortgage brokers are regulated by more than ten federal laws, five federal enforcement agencies and at least forty-nine state regulation and licensing statutes. Moreover, mortgage brokers, who typically operate as small business owners, must also comply with a number of laws and regulations governing the conduct of commercial activity within the states."¹

¹ "Mortgage brokers are governed by a host of federal laws and regulations. For example, mortgage brokers must comply with: the Real Estate Settlement Procedures Act (RESPA), the Truth in Lending Act (TILA), the Home Ownership and Equity Protection Act (HOEPA), the Fair Credit Reporting Act (FCRA), the Equal Credit Opportunity Act (ECOA), the Gramm-Leach-Bliley Act (GLBA), and the Federal Trade Commission Act (FTC Act), as well as fair lending and fair housing laws. ... Additionally, mortgage brokers are under the oversight of the Department of

In addition, “Mortgage brokers are licensed or registered and must comply with pre-licensure and continuing education requirements and criminal background checks in forty-nine states and the District of Columbia. Additionally, over half of these states require not only mortgage broker licensure, but the licensure or registration of brokers’ individual loan officers as well. An increasing number of states are requiring these originators to pass tests in order to become licensed.” However, “ The same is not true for the thousands of loan officers employed by mortgage bankers and other lenders, who are exempt in most states from loan officer licensing statutes. While the Office of the Comptroller of the Currency exempts depository institutions from state licensing requirements, the states continue to increase their regulation of mortgage brokers and their individual loan officers. Many states also exempt lenders from licensing if they are approved by Fannie Mae or HUD, which subjects those lenders and their employees to significantly less regulation than most mortgage brokers. As small businessmen and women, mortgage brokers must also comply with numerous predatory lending and consumer protection laws, regulations and ordinances (i.e., UDAP laws). Again, this is not true for a great number of depository banks, mortgage bankers, mortgage lenders and their employed loan officers, which remain exempt due to federal agency preemption. Many states also subject mortgage brokers to oversight, audit and/or investigation by mortgage regulators, the state’s attorney general, or another state agency, and in some instances all three.”

Further, consumer protection organizations have provided extensive evidence concerning the failure of regulatory agencies to apply existing regulations.² Even before the introduction of the Financial Modernisation Act (GLB) in 1999 bank holding companies had opened mortgage affiliates, or purchased independent consumer finance companies that had entered the market for sub prime mortgages. Even though the Fed was granted responsibility for the supervision of bank holding companies, it decided that these affiliates would not be supervised for compliance federal laws protecting borrowers since they had not been previously subject to regulation. In January 1998 the Board of Governors unanimously decided to formalize a long-standing practice, "to not conduct consumer compliance examinations of, nor to investigate consumer complaints regarding, nonbank subsidiaries of bank holding companies." This decision was then applied to any nonbank that became the affiliate of a bank holding company. A 1999 report by the General Accounting Office warned that the Fed's decision created "a lack of regulatory oversight," because the Fed alone was in a position to supervise the affiliates. Its role as regulator of bank holding companies was strengthened in the GLB Act, but was only exercised for mortgage originate through the banking affiliate of the holding company.

Thus just as banks were moving their capital exposure to mortgage lending off balance sheet through the creation of special purpose entities, they moved these activities outside the purview of regulators by

Housing and Urban Development (HUD) and the Federal Trade Commission (FTC); and to the extent their promulgated laws apply to mortgage brokers, the Federal Reserve Board, the Internal Revenue Service, and the Department of Labor.” National Association of Mortgage Brokers See http://www.namb.org/Images/namb/GovernmentAffairs/Word_From_Washington/WFW%202006-11%20%28Regulation%20of%20Brokers%29.pdf.

² See Responsible Lending, “Neglect and Inaction: An Analysis of Federal Banking Regulators’ Failure to Enforce Consumer Protections,” <http://www.responsiblelending.org/mortgage-lending/policy-legislation/regulators/regulators-failure-to-enforce-consumer-protections.html>.

creating and acquiring mortgage affiliates that were technical regulated but had been declared outside the purview of Fed supervision. As a result, around 13 percent of the national total of sub prime loans made between 2004 and 2007 by bank affiliates were essentially unregulated even though the Federal Reserve formally had the power to do so. A 2000 joint report on predatory lending by the Treasury Department and the Department of Housing and Urban Development noted the failure of the Fed to use its authority to investigate evidence of abusive lending practices, and urged a policy of targeted examinations.³

³ "As Subprime Lending Crisis Unfolded, Watchdog Fed Didn't Bother Barking," by Binyamin Appelbaum, Washington Post, Sunday, September 27, 2009.
http://www.washingtonpost.com/wp-dyn/content/article/2009/09/26/AR2009092602706_pf.html.

THE FED DEMURS . . .

OLD POLICY

January 1998: Fed formalizes its practice of not overseeing bank affiliates, a group of large subprime lenders.

November 1999: The General Accounting Office urges the Fed to reverse its policy.

June 2000: The Treasury and HUD make the same recommendation in a joint report.

January 2004: The GAO again urges the Fed to conduct regular examinations.

CHANGE IN DIRECTION

July 2007: The Fed announces a pilot program to examine some affiliates.

NEW POLICY

September 2009: Fed scraps the 1998 policy, launches regular exams of remaining affiliates.

. . . THE BANKS DO BUSINESS

Banks start subprime lending through affiliates:

March 1998: First Union, a major North Carolina bank, buys the Money Store.

April 1999: Citicorp merges with Travelers and its Commercial Credit subsidiary.

September 2000: Citigroup buys Associates First Capital.

April 2001: Countrywide Financial buys a bank, comes under Fed oversight.

November 2002: HSBC agrees to buy Household and its Beneficial subsidiary.

2004-2007 Period of peak subprime lending by affiliates

Banks end subprime lending through affiliates:

March 2007: Countrywide converts to thrift charter, exits federal oversight.

November 2008: Wells Fargo consolidates its finance arm, Wells Fargo Financial, into its bank.

January 2009: Citigroup announces plans to sell CitiFinancial.

March 2009: HSBC shutter Household and Beneficial.

Source: Washington Post, op. cit. <http://www.washingtonpost.com/wp-dyn/content/graphic/2009/09/27/GR2009092701115.html?sid=ST2009092602937>

Thus, the response was quite simply to make sure that the abuses in the existing system were eliminated. According to the Washington Post article, "The Fed's performance was undercut by several factors, according to documents and more than two dozen interviews with current and former Fed governors and employees, government officials, industry executives and consumer advocates. It was crippled by the doubts of senior officials about the value of regulation, by a tendency to discount anecdotal evidence of problems and by its affinity for the financial industry." This seems to be a clear example of the damage that can be done by applying regulations on the basis of a model in which financial instability is an exceptional, rather than a normal, occurrence. It clearly limited the ability of supervisors to see beyond the problem of the unregulated mortgage affiliates to the wider question of the impact on the solvency of the bank holding companies themselves.

Mortgage Securitisation: Unregulated Off Balance Sheet Affiliates

Although house prices had stopped increasing in many areas by mid 2006 and defaults and foreclosures had reached a sufficient level to cause distress and eventual bankruptcy for some of the larger mortgage originator institutions such as New Century in the first quarter of 2007, it was only the discovery of the contingent liabilities that many large financial holding companies had issued to arms-length SIVs that brought the second phase of the mortgage crisis. It is interesting that at this stage the viability of the securitized sub-prime loan vehicles, their AAA credit ratings and the role of monoline insurers and credit default swaps in supporting those ratings had yet to fully appear. Rather it was the absence of variable interest entities known as Special Investment Vehicles on the reported balance sheets of banks and the regulations that governed their accounting procedures. These entities were the result of two trends in the financial markets of the 1980s when the barriers between fixed interest securities and equities was breaking down under the invention of the junk bond.

In 1998 two Citibankers, Stephen Partridge-Hicks, and Nicholas Sossidis set up a fund that would issue short-term commercial paper and medium-term notes to investors, then use the money to buy higher-yielding longer term collateralized obligations of commercial real estate or credit card receivables that were just being perfected. The fund's assets would belong to the holders of the medium term notes, who would be responsible for the fund's debt if the commercial paper funding dissolved. The assets would thus stay off the bank's balance sheet but would generate fees from originating the assets and organizing and servicing what was to become the model for the SIV and a major destination for bank securitized sub prime loans.

The second element that supported the use of SIVs was the regulatory response to the use of off balance sheet entities in the Enron bankruptcy. Enron had used these vehicles for a different purpose, the generation of income from fictitious sales that allowed the company to manipulate its reported earnings figures and thus its stock price. For banks, the advantage lay in the ability to remove the entities from their consolidated reporting, and thus to reduce or eliminate the amount of regulatory capital that had to be held against them. The regulatory adjustment to accounting requirements for off balance sheet entities were thus driven by different needs and to eliminate a different problem than was at issue at Enron. The resulting changes provided substantial support for the use of such entities by banks after the new regulations were introduced in 2002.

The United States Accounting Standards Board restricted the use of off-balance-sheet accounting in the wake of Enron. The original rules had been based on the share of equity ownership in the entity. The share at which consolidation would be required was set by interpretation at 3 percent of the equity. Thus, in the case of Enron, it was not required to consolidate any special entity in which it had less than 97 per cent of the equity. (the problems were created by the fact that Enron employees were providing the 3 per cent with funds lent by Enron but that is another story). The new FASB rules moved away from a simple rule on equity ownership and concentrated on effective control through the ability to influence the daily operations of the company and the assignment of loss if there were a decline in asset values. This revision created the variable interest entities, or VIEs, as the post-Enron version of special-purpose vehicles, the term for the investments Citigroup created that led to the demise of the energy-trading company. The SIV provided a perfect example of a qualifying VIE since the originating bank had no equity interest, nor did it bear the first risk of loss if the commercial paper could not be rolled over and the assets sold at a loss. They thus became a repository for the AAA tranches of the securitized sub prime mortgage obligations, but were not reported on any major bank's consolidated balance sheet. Neither did the assets require provision of bank capital.

When troubles with subprime mortgage loans became an issue in the summer of 2007, SIVs didn't appear to be affected because it was thought that few had exposure to subprime loans. In July Moody's Investors Service considered SIVs "an oasis of calm in the subprime maelstrom." However, by late July, a bank affiliate set up by German bank IKB Deutsche Industriebank reported funding difficulties and in August Cheyne Finance, a \$6.6 billion SIV operated by a London hedge fund, began liquidating assets to repay debts. On Sept. 6 Citibank announced that its SIVs had little subprime exposure, but that it was also selling assets.

Thus, the sub prime mortgage lending carried out by a large bank holding company could escape supervision if it took place in a mortgage affiliate, and the mortgages that it generated could escape market scrutiny if the mortgages were packaged into collateralized mortgage obligations that were sold to Special Investment Vehicles that were not subject to supervision of capital adequacy and were regulated, if at all, as Section 144 assets under the SEC – that is as private transactions whose contents and details need only be provided to the buyers of the securities.

Again, there was no lack of regulation, indeed, the SIVs were made possible by reregulation that was supposed to prevent the kind of abuse of off balance sheet entities that had occurred under Enron. When it was discovered that many banks had written liquidity puts similar to back up lines of credit to the issuer of commercial paper by a private company that might require the banks to cover the difference between the liquidation value of the subprime CMOs and the commercial paper falling due, the response was to create a bank pool to absorb the assets to prevent their sale and to urge bank recapitalization to cover any potential losses. Many large banks at this stage sought capital injections from sovereign wealth funds or wealthy individual investors such as Middle Eastern Oil Sheiks or Warren Buffet. Many banks in the end simply took the asset back onto their balance sheets, given that most still carried AAA ratings. Again, the response was to provide a remedy in the form of plugging the loss of capital and changing the accounting rules governing consolidated reporting. This goes on today, and is generally focused on the active or passive nature of the originating bank to influence day to day

operations and in requiring an ongoing assessment of the classification of variable interest entities when the risk exposure of the bank may change over time. Basically, the problem was simply seen as providing enough capital to allow the banks to take the assets back on their balance sheets and to meet residual losses due to the relatively small proportion of sub prime mortgages involved.

Thus, by the end of 2007 and the beginning of 2008 it was again believed that the sub prime exposure problem was well contained. Well contained because it was believed that the system would now revert to normal, having taken care of the mortgage affiliates and the off balance sheet affiliates. The stage was set for the third stage which started in March with the collapse of Bear Stearns and ended with the bankruptcy of Lehman which brought the entire financial system to a halt.

A Run on Investment Banks

The third stage of the crisis occurred not in the traditional fashion of a deposit run (although there were lines of depositors seeking to remove their funds from Northern Rock in the UK). Rather, it occurred in the investment banking sector, the sector which is supposed to be immune from such panics, and if it does is supposed to be able to meet bankruptcy without disrupting the payments system. The idea of mark-to-market accounting has played a substantial role in the discussions of the evolution of the crisis. Its genesis however provides a clue to the problems that were faced in the third stage of the crisis. Mark-to-market accounting was originally introduced by the Securities and Exchange Commission in assessing capital requirements for broker-dealer investment banks. The idea is that a broker dealer will in general finance its inventory with short-term money. The classic case in the pre GLB world was the specialist on the New York Stock Exchange who finances its inventory of stock by using it as collateral for call money borrowed from a New York deposit taking bank. Since funding had to be renewed everyday (or indeed on call) the collateral had to be repriced (marked to market) every day to insure that its value was sufficient to repay the borrowing from the banks. The capital requirement was the equivalent of the haircut on the value of the securities, or the margin of error to ensure that the broker dealer was truly solvent. The persistence of any investment bank thus depends on the one hand on the value of its inventory of assets, and its ability to refinance those assets on a more or less continuous short-term basis. We have already seen how in the second stage of the crisis doubts over the value of the assets held by SIVs led to difficulty in refinancing via the failure of investors to buy its asset back commercial paper. That experience led to doubts about the ability of commercial banks to meet their lending commitments in support of sub prime mortgage assets. But, the entire financial system was operating on the same basis of borrowing short-term funds to finance holdings of mortgage assets.

One of the main characteristics of the was that deregulation had brought about the erosion of Section 20 restrictions on bank activities was the creation of the repo market in which banks would lend against collateral, initially government securities. This meant that an investment bank could finance its assets holdings through a repurchase agreement with a commercial bank. This meant that the bank was lending short-term to the investment bank to finance its speculative holding of government securities. Eventually, investment banks learned that they could lend to their clients, such as hedge funds, to support their speculative positions by lending the securities of the hedge funds they held as collateral. It was thus possible for a hedge fund to leverage its portfolio by 20 to 40 per cent by borrowing from as

investment bank that was itself leveraging by a similar amount using the securities held as collateral for the hedge fund client. This relationship, called a prime brokerage account, provided the hedge fund not only with leverage, but also the execution of its trades and other technical services, all of which earned fee and commission income for the investment bank. But, the main point is that an increasingly long chain of short-term lending or financial layering was supporting long-term assets, with increasing leverage. And at the basis of the system was a deposit taking bank affiliate of a bank holding company. And the assets that were being funded were the collateralized subprime mortgage obligations. This system would have been extremely fragile and subject to collapse even if the mortgage assets had been perfectly sound, but they were not.

Indeed, the problems on the asset side were not only due to the increasing defaults due to the onerous terms and fraudulent origination activity. A collateralized obligation is not a standard security, i.e. the liability of a chartered private corporation. It is a financial institution, usually a trust, and it issues securities whose credit rating is determined by the structure of the liabilities and the owners' equity. This owners' equity was the medium term note in the SIV. In a CMO it is the equity tranche, usually no more than 4 or 5 per cent of the total asset value, usually supplemented by a guarantee given by a monoline insurer who has far less than 1 per cent of assets against its liabilities, or by a credit default swap written by another bank or by AIG, in which case the reserve was not even 1 percent. The AAA credit ratings that were given to 90 to 95 of the value of the assets issued as securities thus were the equivalent of being reserved by short-term money. Borrowing by the insurers would be required to meet the guarantees. Thus, there were pyramids on both sides of the balance sheets of investment banks—their assets were pyramided and their liabilities were pyramided.

Thus, when questions were raised, first about Lehman, and then about AIG, it was as if the short term loans and the margin requires were called on both sides of the balance sheet of the investment banks and the result was the equivalent of a bank run. Since the deposit banks were already facing capital constraints due to the SIVs, they could not provide funding, it had to come from other investment banks. But they were all looking for alternative funding, as were the insurers. The hedge funds, fearing loss of their funds held on deposit sought assurance and started to withdraw their funds. Faced with the impossibility of funding their asset positions, the only alternative would have been to sell assets which had no buyers. Mark to market in these conditions would clearly have led to zero prices and insolvency of the entire system.

It was at this stage that the Treasury and the Fed decided that a systemic solution was required to support asset prices on the one hand, through the request to Congress for Tarp funding, and the Fed decision to lend to any and all institutions to allow them to meet short term funding requirements. It handsomely proved Minsky's rule that the stability of an institution depends only the ability to sell assets for cash, and only the Fed can provide cash in unlimited amounts.

Again, there was no lack of regulations involved in the build up of financial layering and pyramiding on an ever declining cushion of cash. The response has been to try to act on the value of assets and to provide liquidity. Indeed, the problem is seen as a liquidity induced collapse in asset prices, rather than any inherent problem with the assets themselves. However, the assets are insolvent, as are

the institutions that hold them. The failure to recognize this is at the root of the failure to provide any meaningful reform of the system. As long as the policy is that the problem is a liquidity crisis, and that providing unlimited amounts of liquidity will eventually allow asset prices to return to levels that allow banks to remain solvent with minimum capital injections, there can and will be no meaningful reform or regulation of the financial system.

What was different about the New Deal?

If the current reform effort has proven to be unable to bring about a fundamental change in the operations of banks, what is different about prior periods in which fundamental change did take place? In the 1860s the US was just emerging from the Jacksonian experience of the National Treasury System in which the US government ran its affairs on the gold standard, while allowing almost free reign to private banks to produce bank notes. The need for a mechanism to deficit finance the Union army as well as the need to provide regulation of the issue of private bank notes coincided with the creation of the greenbacks and then the creation of the National Bank System in which only National Associations could issue national bank notes that were backed by the sovereign debt of the US government. It brought Federal control of a large part of the banking system through the Office of the Controller of the Currency, and better prudential controls of state chartered banks. While state banks survived, largely through the innovation of transactions deposits, there was a basic shift away from the use of the market to regulate banks by allowing free chartering to a system based on government regulation and prudential controls.

The panic of 1907 brought the eventual creation of the Federal Reserve System and the shared responsibility for prudential regulation between the OCC and the Federal Reserve.

The New Deal was a rather different experience. The collapse of the stock market in 1929 had ruined many individuals, many through investments that they had made in state chartered securities affiliates of national association banks. But the real impact only became evident when the impact on the real sector caused bank weakness and bank runs that the Fed was powerless to halt. The Hoover administration had moved to support the system through the Reconstruction Finance Corporation (following a system that Jesse Jones had introduced in Houston to rescue its troubled banks), but banks had continued to fail and most state governors had already called for bank holidays by the time Roosevelt came to office and converted the de facto national bank holiday into an official holiday. Thus, the securities affiliates that had been the source of much of the fraud and speculation had already been closed, and most other banks faced liquidity runs that they could not withstand.

Thus when Jesse Jones arrived and allowed a bank to open with a preferred investment in the bank's capital the choice was to accept or to lose the bank. When his representatives participated in the management of the bank, there was no question about whether this was permitted.

Second, the new bank regulations were formulated quickly, and with a very precise objective. It was widely accepted that the problems had been caused by the operation of securities affiliates by national banks who were primarily deposit takers. The aim of the banking act was to prevent deposit taking banks from operating securities affiliates, not the separation of commercial banks from

investment banks which was just a natural corollary. Indeed, historians suggest that not much attention was paid to regulating investment banks at all, they were more or less free to do whatever they wanted as long as they did not take deposits. This is clear from the conundrum faced by the premium investment bank of all time – J P Morgan. Morgan recognized that it would be difficult for the bank to operate as banker to the corporate world without offering transactions accounts. For example, where would the funds raised from a bond issue be kept if not on deposit with Morgan? Thus the seemingly unnatural decision to become a commercial bank and allow some of the partners to leave to form the investment bank Morgan Stanley.

It was also widely accepted that the reason that commercial banks had ventured into the securities field in the first place was that their revenues from commercial banking were being eroded by competition from equity markets. During the stock market boom it became much easier to finance even short term operations by issuing stock through an investment bank than to borrow from a commercial bank. Thus, the second part of the legislation that was very clear was that it had to limit competition with commercial banks, to guarantee them an income for providing commercial banking services which involved providing safe and secure transactions deposit accounts and providing funding for the short-term needs of productive enterprise. Thus, Regulation Q fixed the cost of inputs at zero, by setting the rate of interest paid on core deposits at zero, and the creation of deposit insurance fixed the cost of providing safe and secure deposits at the level of the insurance premium.

The only additional cost was that the bank should be subject to regulation by the Federal Reserve and that its lending should be limited to what have come to be called commercial and industrial loans. This also reflected a very clear idea about what banks should do. The US financial system from the time of the National Bank Act to the Federal Reserve Act had been based on what is usually called the “real bills” doctrine. It was the basis of what was thought to be the elastic currency created by the Federal Reserve, and depended on banks lending to collateralized, self-liquidating business loans. While the elasticity part of the doctrine has always been suspect, and became subject to increasing criticism, the prudential side of the theory remains clear. As long as banks are financing goods to be sold housed in warehouse or under contract production, the lending will be self-liquidating when the goods are sold. When the lending is set against the liquidation value of the goods being produced or sold, the loan is by definition short term and well collateralized.

Thus, Glass-Steagall had written into legislation a floor return to banks in the form of Regulation Q and the hedging on their assets and liabilities in the form of self-liquidating commercial and industrial loans and deposit insurance. In short, the Roosevelt legislation had a clear plan of what banks could and could not do after regulation and the conditions that would insure that their returns would be sufficient to keep them from looking for other activities.

Any meaningful reform must thus start from a clear view of what the financial system is supposed to do. Minsky always argued that its role was to finance the productive investment of the private sector. Its success in this could be measured in terms of its ability to increase employment and real wages, which would provide a more stable system. On the other hand, if the objective is to promote financial innovation and the efficiency of the finance system in the sense of eliminating price

discrepancies, producing the maximum profit given capital investment then the system will remain inherently unstable. In particular, the moves to increase capital requirements, as well as insurance premia, only provide incentives for banks to engage in increasingly risky practices. Until regulation builds prudential hedging into bank regulations, and builds a design for the system that supports growth and employment, it will remain subject to “It” happening again. The lessons of Glass-Steagall reform are thus not simply separation of banking and finance, they are the necessity of legislating a system that provides sufficient returns and circumscribes risks that can be undertaken by financial institutions.