The Pools – A Glimpse at the World When the Financial Crisis Has Passed

By Stephen J Nelson; The Nelson Law Firm, LLC

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In a prior article, we discussed "pools and puts," which were regarded by the Congress that enacted the Securities Exchange Act of 1934 as the primary causes of The Great Depression. The "pools" that were erected in the 1920s and were later subject to Congressional denunciation were called "investment trusts." They were essentially hedge funds, unregulated investment companies that purchased large positions in operating companies and increased those positions through borrowing and by purchasing and issuing options.

The period of the Great Depression and its causes are instructive for those of us who are determined to learn from history, rather than repeat it. Then, as now, we are encountering a credit crisis, which involves cascading bank failures. That is, the weaknesses of one bank causes other banks to fail. There is a crisis of confidence with investors withdrawing capital from the markets and seeking safe havens – treasury bills, for example. The government becomes a lender of first resort.

Nonetheless, that was then, and things are different now. For one thing, I haven't heard about anyone stuffing currency into their mattress, although one British economist recently joked about putting bills in a stocking in an undisclosed location. And, people are buying gold bars faster than they can be produced. None of these strategies are particularly appealing to most of us. I just can't envision Stop N Shop accepting gold in payment for groceries in this enlightened day and time.

The fact is that the last credit crisis experienced in this country occurred in the 1930s. Very few of us now living can recall a period of cascading bank failures. Prior to the 1930s, however, the United States went through a credit crisis about every 10 years, which is one reason why public officials of the time responded with too little, too late. They simply didn't appreciate the magnitude of the event, until it was too late. The Great Depression got the attention of the American people, and they responded by voting for politicians who treated the crisis very seriously.

The Exchange Act Congress briefly considered doing away with capitalism altogether, but was ultimately persuaded that the problem could be fixed with an elaborate regulatory scheme. Commercial banks were divided from investment banks and regulated by different government agencies. Insurance companies were separately regulated by the States. Commercial banks were forbidden to become equity owners in commercial enterprises. And, since bank failures seemed a root

cause of the problem, extreme efforts were taken to enhance the “safety and soundness” of commercial banks. The ability of commercial banks to extend credit was regulated by capital requirements, and an insurance program was adopted to ensure that depositors would never again lose their money in a banking failure.

As it happens, those regulations that improve the safety of banking institutions also reduce their profitability. So over time, legal minds have responded to the pleas of their clients by whittling away at the distinctions among commercial banks and other institutions created in the 1930s. Some very respected economists have argued that this breakdown in regulatory structure is to blame for the current credit crisis. While I respect those views, I think returning to 1930s regulation is impractical and doomed to failure.

For one thing, those economists arguing for “strengthened regulation” underestimate the capacity of the well-financed legal mind to “get around the rules” by undermining hard and fast legal distinctions, no matter how well they are crafted. When this crisis has passed, which it will some day, memories will eventually fade. It is in this environment that regulations that limit profitability will be seen as overly-protective and obsolete. Lawyers, like termites, will chip away at their foundations, leaving us to experience yet another credit crisis.

I propose a different approach to correcting the problem.

The fact is that commercial banks, investment banks, insurance companies and pension and investment funds are all pools. Their business is to obtain money from others, whether it is called a deposit, a loan, a premium, an equity investment or something else, and use that money to make investments in financial instruments. They are not in the business to manufacture anything, and setting aside certain administrative services provided by banks and broker-dealers, generally are not organized to provide services, either.

A pool that invests money obtains a financial instrument in exchange. It is worth noting that this sort of activity is different than the actions of a manufacturer of, say, light bulbs. The light bulb manufacturer uses investment capital to buy light bulb making equipment and hopes to profit by selling enough light bulbs at a high enough price to pay for the equipment and the employees who run it with some profit left over to share with investors.

What happens next launches us down the primrose path to crisis. Pools can borrow money based on the financial instruments they have acquired. They can then make additional investments and use those investments to borrow more money. The borrowings can take the form of an outright loan. Alternatively, pools can use the financial assets they have acquired to produce options or their cousins, swaps. Option, swaps and other derivative instruments are simply loans in disguise.

Economists think of this process as the creation of money, since the pool multiplies the original deposit many times through repeated borrowings and relending, resulting in an increase in the amount of money in the system. The more pools that work at this task, the more the money supply expands.

The more times the original deposit, premium or equity investment is used to borrow money, whether in outright loans or derivative instruments, the more profitable the pool. The managers of the pool therefore have a great incentive to borrow as much as they possibly can. Borrowing is sometimes called leverage because in the same way that a lever can vastly increase the ability of its user to move objects, borrowing dramatically increases the profitability of pools. As anyone who has used one for a serious purpose can tell you, the power of levers also makes them dangerous to their users and others. Similarly, the use of financial leverage exposes its users to great risk of loss, and that risk can also cause losses for other investors who use leverage more judiciously, as well as persons with very little interest in financial instruments.

Leverage also increases the profitability of manufacturers and service providers, but there is a limit. Eventually, the light bulb manufacturer can no longer sell light bulbs at a price high enough to pay for the last light bulb machine. When this happens, the manufacturer cannot make light bulbs profitably and cannot pay back the loan used to buy the light bulb machine. If a lot of manufacturers and service providers face the same problem at roughly the same time, pools will also default on their obligations to their lenders and depositors, and there will be a crisis.

To avoid crisis, it is necessary to regulate the amount of leverage that can be injected into the economy by pools. And, prompt regulatory action needs to be taken when loan defaults indicate there is too much leverage in the system.

The Exchange Act Congress did not enact this sort of regulation because it attempted to distinguish among the different types of pools. The amount of leverage that could be incurred by banks was strongly regulated because bank runs were regarded as an evil that needed to be avoided at all costs. Most bank regulation is designed to prevent runs. Broker-dealers also had net capital rules, but these were largely intended to protect their customers from default, rather than protecting the system from leverage. The systemic leverage that could be produced by broker-dealers generally was limited by less carefully supervised margin rules. Insurance companies were also limited in the leverage they could produce to protect policyholders from their failure, rather than protecting the system from leverage-induced crises.

Oddly, no leverage limitations were imposed on investment companies. Probably, this was simply an oversight. The more radical members of the Exchange Act Congress hoped to ban investment trusts and related instruments from the face of the earth. But, that approach was too extreme for the majority. So, things drifted along

until 1940, when Congress adopted the Investment Company and Investment Advisers Acts of 1940. By then, the passion for capital regulation had ebbed.

This was unfortunate because, over the last decade or so, these unregulated pools enjoyed enormous profits through increasing use of leverage. Regulated banks, broker-dealers and insurance companies pressured their regulators to let them in on the fun. The result is that the leverage in the global economic system was ramped up to the breaking point. We are now experiencing a grand collapse. If history is any guide, there will be unemployment, both of people and resources, until the last unprofitable bit of leverage is wrung out of the system or purchased by the American taxpayer. Then, the process will start all over again.

But why should history repeat itself? The mistake made by the Exchange Act Congress was to treat pools differently. Why not treat them all alike, at least insofar as they have the capacity to lever the financial system? Under this system of regulation, banks, broker-dealers, insurance companies, and pension and investment funds would all have roughly similar capital requirements.

As it happens, this was the first recommendation of the report to the European Parliament made on April 18, 2008. The recommendations of the President's Working Group in March 2008 would have preferred more reliance on the market to impose appropriate capital discipline, a notion that seems increasingly quaint as the Fed nationalizes everything in sight.

It may seem odd to discuss ways to prevent future crisis when the current calamity is still unfolding. But, this too shall pass, and I believe it is not too early to consider what the world will look like when the process is complete.

I think it is inevitable that when the smoke from the current crisis clears, there will be a uniform system of capital regulation, probably administered by the Fed. It is even possible to imagine a global capital regulator, since one of the reasons things got so far out of hand is that hedge funds that felt constrained by US margin rules took their business offshore, where broker-dealers were not obliged to follow customer protection rules and would permit virtually unlimited margin.

A uniform system of capital regulation would enhance the safety and soundness of pools. On the other hand, the system would also limit the profitability of pools. The question is whether it can be implemented without completely stifling economic growth.

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