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The financial crisis' unintended consequence

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With the U.S. Senate about to formally begin deliberating legislation aimed at preventing another financial crisis, much of the focus has rightly been on derivatives, securitization practices and “too big to fail” financial firms. Largely unnoticed, however, is an effort to extend regulation to hundreds of American businesses that are only indirectly engaged in the financial markets and had nothing to do with the Wall Street meltdown of 2008.

Both the House and Senate bills are based on ideas originated by the U.S. Treasury. Major provisions in each proposal are intended to ensure that banks and investment firms are never again allowed to demand hundreds of billions of taxpayer dollars in bailouts. This includes provisions to strengthen securitization practices and regulation of over-the-counter derivatives. On top of these proposals is also the creation of a “systemic risk” council with authority to impose strict capital requirements and other limitations on financial companies that are deemed to be a danger to the health of the economy.

But each proposal takes the unprecedented additional step of extending this systemic risk regime not just to banks, which are already subject to similar requirements, but to any company engaged in “financial activities.” The term “financial activities” is taken from the Bank Holding Company Act of 1956 and broadly means any type of financing, lending, investing, real estate leasing or consulting that a bank holding company can engage in. These same “financial activities” have been a routine part of the daily business of most large corporate firms for decades.

For instance, many energy companies make markets in derivatives in order to provide their clients with risk management options as well as to take advantage of their expert knowledge of energy markets. Houston is a leading center for energy firms’ trading operations. Many successful companies have large, proprietary portfolios that they trade as an additional source of diversification and revenue. And many non-financial businesses have finance arms that they use to deploy excess capital. Importantly, none of these activities were even remotely involved in the financial crisis or contributed to systemic risk.

Yet under the current proposals these businesses are all transformed into “financial companies” that could become subject to regulation by the Federal Reserve as though they were a bank holding company. As such, they would be required to hold cash in reserve and refrain from certain activities as though they were the same as a large banking firm. They could even be required to break up into smaller companies or sell off certain assets. As a practical matter, it means the resource providers, manufacturers and retailers that might suddenly find themselves regulated by the Federal Reserve would be unable to freely use all their capital for hiring and research.

Another consequence of the legislation would be that these same companies could be forced to pay the costs of a financial institution that took too much risk. Under the proposals, regulators would have the authority to wind down a “risky” company similarly to how failed banks are resolved. The proposals would be paid for by a charge on other systemically risky firms. The practical effect of this would be that a company like IBM could end up having to pay for the failure of a large bank holding company like JP Morgan, were it ever to fail.

Perhaps the most important consequence about these proposals is their potential to extend to commercial firms the application of “too big to fail” policies, the current albatross around our system of financial regulation. The current systemic risk proposals create the possibility that virtually the entire economy could become subject to bank-like supervision. Given that being regulated as a bank increases the possibility of one day being deemed “too big to fail” and hence eligible for taxpayer-funded bailouts, extending bank-like regulation to commercial firms is something that deserves far closer attention. While expanding the scope of systemic risk oversight may sound good in theory, bailing out failed companies simply because their financial activities had caught the attention of regulators would be nothing but bad in practice.

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