Financial Sector Development in the US: What can we learn from it?

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The US has the oldest, most extensive, and the most well developed financial sector in the world. This sector helped channel savings and capital efficiently for nearly a century, which helped propel the US to become by far the largest economy in the world. It has been the center of most financial innovations in the world that has helped growth in virtually every part of the global economy. However, this very sector was at the center of the deepest global financial crisis the world has seen since the Great Depression. What made this sector so successful, and then made it fail so spectacularly? What were the cornerstones of innovation in the US Financial System? Where did it go wrong? This article will throw some light on some of these issues, and the ramifications for other countries that are currently in the process of opening up and developing their financial systems and structures.

A bit of history is important in understanding financial sector development in the US. The financial services industry in the US owes its origin to commodity trading in the mid-nineteenth century. Entrepreneurs like Henry Lehman migrated from commodities trading to full fledged financial services (Lehman Brothers). The Federal Reserve System (central bank in the US) was formed in the early part of the 20^{th} century to provide banks with ready access to short term funds as well as to regulate their functioning. The biggest change came in 1933, in the wake of the Great Depression, in the form of the Glass-Steagall Act, which separated investment banking from commercial banking – institutions had to choose one or the other. This led to the emergence of large investment banks (such as JP Morgan, Goldman Sachs, Lehman Brothers, etc.) and large commercial banks (such as Citigroup, Chase, Bank of America, etc.). However, since the mid 1980s, several provisions of this separation were weakened, leading to the eventual repeal of this Act in 1999. This was a watershed event in US financial history, since it led to mega mergers in the banking industry and the evolution of "Universal Banks".

Therein lies one of the problems. Much has been said about "Too Big to Fail". These mega institutions like Citigroup pose enormous systemic risk if they fail, since they are connected to virtually every sector of the economy either directly or indirectly. This creates the "moral hazard" problem, where such institutions have a tendency to take on excessive risk, since they (correctly) believe that no government will let them fail even if they lose all their capital. This is indeed what we saw during the financial crisis in 2008. Is the problem the aggregation of investment banking business with commercial banking activities, or is it simply an issue of size? I think both. It will never be possible to stop information from leaking from one part of the business to another – there will always be problems if one part of the bank has inside information about clients which it conveys to another business unit that is on the investment side. This separation of activities makes sense, and served the US and the global economy very well for half a century. Size is the bigger problem though. If there is any lesson to draw from the current crisis, it is that “too big to fail” should be “too big to exist”. No amount of regulation can really control the risk taking activities of financial institutions well. They should never be allowed to grow to such a size that they can hold the whole economy hostage. Countries (like China) currently thinking about reforming their financial system should pay heed to these two lessons from the experience in the US.

The central source of the current financial crisis lies in the abuses that occurred in the mortgage industry in the US. Ever since the formation of the FNMA (Fannie Mae) in 1938 and its conversion to a GSE (Government Sponsored Enterprise) in 1968, along with the formation of the GNMA (Ginnie Mae), giving Americans the ability to own homes has been one of the key social objectives that has been furthered by every administration. Access to mortgage loans was continuously improved. The big shift occurred with the advent of securitization in the 1970s – the financial innovation that allowed institutions to originate home loans and sell them off to investors and other financial institutions, who then packaged these loans into a common pool against which they sold debt securities of varying risk-return profiles. This drastically increased the flow of capital from all sectors of the economy to homeowners. This was, again, a good step – upto a limit. Excessive deregulation of this industry, from the 1980s onwards, led to the extreme abuses that we witnessed over the last decade, that brought the entire global economy to a standstill.

Again, what went wrong? Securitization is a wonderful financial innovation. It is an extremely efficient and effective way to allocate capital to sectors of the economy that otherwise would be starved for capital. It also lowers the cost of capital for many borrowers. It did that for homeowners too. That was a good thing. However, lack of appropriate regulations and lack of transparency allowed financial institutions to abuse this system as well. Banks that originate loans (mortgage or others) and then sell them off have no “skin in the game”. They have no incentive to originate “good” loans – they can give out loans even to borrowers who are not creditworthy as long as there are investors ready to buy them. Why would investors buy bad loans? This is where lack of transparency hurts. By creating complicated structures such as CDOs (Collateralized Debt Obligations) and super derivatives such as CDO-squared securities, banks were able to hide the true quality of the underlying loan portfolios. Investors were just not sophisticated enough to evaluate these securities appropriately. Then why did they buy them in large quantities? Perhaps greed had a big role to play here. In addition, the rating agencies failed to do due diligence in rating these complicated structures, thus practically misleading them.

The biggest lesson from the mortgage debacle in the US is to ensure that banks that originate loans must be required to continue to have some skin in the game, i.e., they should be required to share in future losses if those loans go bad. That is the only discipline that will ensure that banks do appropriate due diligence of their borrowers before giving out loans. In addition, reporting and rating requirements must be strengthened, bringing more transparency to the whole financial system. Last but not the least, extreme complexity should be avoided in designing financial structures and instruments – there is almost never an economic rationale for a very complicated financial instrument. Just the existence of such instruments should trigger enquiry from the regulators.

That leads us to the most complicated part of the financial system – the derivatives industry. Developed from the early 1970s onwards, this has arguably been the biggest and maximum impact financial innovation in the world. Starting with derivatives on equities (simple options and futures) and commodities, it has grown to include almost every asset class around the globe – interest rates, exchange rates, credit sensitive securities, weather indices, etc. More importantly, this industry has evolved from relatively simple derivatives to extremely complex and exotic derivatives that are nearly impossible for the average business manager to even understand, let alone value. These extremely powerful financial instruments allow institutions and individual to take on very large amounts of risk, very quickly, and with very little upfront investment. To make matters worse, they are categorized as "off balance sheet" items, so the disclosure requirements on institutions engaging in these transactions are minimal. This is probably the "eye of the hurricane" in the context of the global financial crisis .

So what went wrong with derivatives? If used prudently, they are extremely effective and useful instruments for companies to manage their risk and create value. However, many firms did the opposite – instead of using these instruments for risk management, they were practically speculating, and in very large numbers – the notional principal amount of all derivatives in the world is reported to be over $1000 trillion!

First, a large part of the derivatives market operates "over-the-counter" (OTC). This means that dealers directly trade with other dealers, without an exchange or a clearinghouse in between to manage counterparty credit risk or report positions. So the extreme holdings of institutions can go undetected, since there is no centralized entity aggregating all positions and reporting them. It also creates enormous systemic risks in times of crisis, since credit risk concerns can drive many counterparties into default, in the absence of margining requirements imposed by exchanges. This is precisely what happened in the now infamous "credit default swap" (CDS) markets. The lesson here is to try and keep as much of the derivatives market as an exchange traded market, with very strict regulatory and reporting controls on the OTC markets.

Second, nothing should be "off balance sheet". The accounting profession must develop appropriate indepth reporting requirements for derivatives. If everyone had to disclose their derivatives holdings, we would never have been in this mess. This will help bring the hidden world of derivatives out of the shadows, and impose market discipline on all participants.

Third, complexity is in itself a cause for concern. There are very few legitimate risk management applications that require complex derivatives. Most companies can effectively manage their risks using simple derivatives like options and futures. Therefore, if at all there is any trading in complex derivatives, it should be heavily scrutinized, since that's where many of the problems start.

Fourth, institutions should be required to hold adequate capital against their derivatives positions. While this has been addressed to some extent, progressively, in different versions of the Basel Requirements, there is still a need for more refined capital estimation techniques for derivatives portfolios. Entering into a derivatives transaction should have some cost, it should never be totally free.

Emerging market economies contemplating introducing and developing derivatives markets in their countries should pay heed to the experience of the US and other economies that have had derivatives markets for decades. While they serve a very useful purpose, they should be treated like powerful medicines – use them to treat diseases, without allowing anyone to have an overdose.

Overall, the history and experience of financial sector development in the US highlights an important dichotomy that must be managed well – between regulation and free markets. It is essential to have a financial system structured as a free market system, since that is the only way it will encourage innovation, efficient capital flows, and value creation for all participants. However, free markets only work well when there is prudent regulation. While over regulation can stifle markets, lack of adequate regulation can create the kind of excesses that we have seen in the recent past, which leads to disastrous consequences not only for the country but for the rest of the world as well. As highlighted in this article, there are many specific steps that China and other countries can take to ensure the development of an efficient and robust financial system.