

Toward a More Stable Financial System

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In recent decades, our economy has become somewhat bifurcated. We have a productive portion of the economy that produces goods and valuable services. We also have a speculative portion of the economy that does not produce goods or valuable services but relies upon trading activity. Although the speculative economy is often a source of financial instability, it is frequently supported by government efforts.

This essay is not meant to be a complete solution to the nation's financial problems. The purpose is to help start a conversation about principles for a sound economic and financial system.

Below are some suggestions to improve the stability of the financial system. Some people will object to some of these proposals because, if implemented, they will likely reduce the revenue and profits of certain financial firms. The purpose of these types of policy suggestions is to:

- Direct more capital and human effort to the productive economy.
- Reduce potential sources of financial instability.
- Reduce the potential necessity of government intervention to maintain financial stability.

Limit the Use of Derivatives

The global derivatives market has experienced exponential growth during the last three decades. The International Swap Dealers Association (ISDA) estimates that the total notional value of over-the-counter (OTC) and exchange-traded derivatives amounted to US\$ 1.73 trillion in 1987. According to the Bank of International Settlements (BIS), the total notional value of OTC and exchange-traded derivatives amounted to US\$ 661.9 trillion as of December 31, 2019. The BIS breakdown of the OTC market is in the table below.

**Global Over-the-Counter Derivatives Market
December 31, 2019**

	Billions of US Dollars	
	Notional Amount Outstanding	Gross Market Value
Foreign exchange	\$92,177	\$2,230
Interest rate	448,965	8,352
Equity-linked	6,874	583
Commodity	2,124	197
Credit derivatives	8,119	222
Credit default swaps	7,578	199
Other	246	15
Totals	\$566,083	\$11,798

Source: Bank for International Settlements

The gross market value is the sum of the values of all outstanding derivatives contracts with either positive or negative replacement values based upon market prices on the reporting date. One firm's positive value on a contract should, in theory, be equal to the negative value on the same contract held by its counterparty. However, since OTC derivative contracts are not standardized and traded on an exchange, the counterparties may be using different methods for estimating fair market value.

According to the BIS, the notional value of global exchange-traded futures and options totaled US\$ 95.8 trillion as of December 2019. \$95.4 trillion of this amount is related to interest rates and the remainder is related to foreign exchange. The BIS does not have reliable information on the notional amount outstanding for exchange-traded equity-linked, commodity, and credit default swap derivatives.

According to the CIA's World Fact Book, the gross world product in nominal terms was US\$ 80.3 trillion in 2017. Thus, the ratio of the notional value of derivatives outstanding identified by the BIS divided by the gross world product is 8.2 and most of the derivatives are concentrated in the European and American economies. The magnitude of the derivatives market clearly exceeds the requirements of nonfinancial businesses to hedge risk. A significant portion of derivatives activity appears to be leveraged speculation.

The US Comptroller of the Currency publishes a quarterly report on US bank trading and derivatives activity. At the end of the first quarter of 2020, the notional amount of

derivatives contracts held by US banks totaled \$197.5 trillion (or 9.2 times US GDP). Interest rate derivatives were the largest category with a notional amount of \$146.0 trillion. The four largest banks with the most derivative activity represented 86.7% of all bank derivatives. The derivatives positions of the largest banks in the US are quite large relative to the size of their own balance sheets and the US economy.

While there may be some uses of derivatives that are beneficial to commerce, the magnitude of the market today suggests that much of the trading is related to highly leveraged speculative positions. The derivatives market is a source of potential instability for the financial markets, especially because most of the positions are held by a small group of large banks.

Eliminate Margin Debt

Margin debt is used by investors and speculators who attempt to improve their returns by borrowing money from a brokerage firm or bank to buy securities. The securities purchased are used as collateral. The use of margin debt contributes to volatility in the financial markets. An increase in margin debt will make prices go higher, but a decline in margin debt will accelerate market declines. From a policy standpoint, margin debt diverts credit from the productive economy and has no direct impact on the production of goods and services.

As of August 2020, according to FINRA (Financial Industry Regulatory Authority) statistics, the margin loans outstanding stood at \$645 billion. During a market decline such as we have seen in reaction to the COVID-19 outbreak, some investors are forced to sell to meet maintenance margin requirements.

The Federal Reserve Board Regulation T sets the initial and maintenance margin requirements. At the present time, the initial margin requirement for purchasing stocks is 50%, while the maintenance margin is 25%.

The elimination of margin debt should take place gradually over an extended period. The initial and maintenance margin requirements could be raised by 5% per year until margin loans are eliminated after 10 years. This process would free up capital to be redeployed from the speculative economy to the productive economy. It should also reduce the volatility of the stock market.

Reduce the Size of the Repo Market

Corporations with funds that exceed the FDIC insurance limits often use the repurchase (repo) market to lend funds overnight or on a short-term basis. The repo market allows a corporation with cash to buy securities with an agreement to sell the security back to the original seller at a pre-established price. The difference between the purchase price and selling price essentially represents interest for a short-term collateralized loan. The securities that are sold and repurchased serve as the collateral.

The repo market is used by hedge funds and securities firms to leverage their positions. Given the short-term nature of this collateralized loan, the money cannot be used to finance productive resources like manufacturing facilities because they require longer-term financing. As a result, the repo market is used either to provide short-term liquidity or to leverage securities positions.

In November 2010, two Yale professors, Gary Gorton and Andrew Metrick, wrote an article titled “Haircuts” explaining how “the financial crisis of 2007-2009 was a banking panic in the sale and repurchase agreement (repo) market.” As the repo market grew over the years, other types of securities besides US Treasuries were used as collateral in the repo market. Asset-backed, mortgage-backed, and commercial mortgage-backed securities (ABS, MBS, CMBS) were used as collateral, as well as collateralized loan and collateralized debt obligations (CLO and CDO). When these securities experienced credit downgrades during the crisis, their collateral values were subject to “haircuts.” Lenders would lend less than the estimated fair market value of the security, which resulted in a contraction of the repo market and forced selling of securities that had diminished collateral value. By contrast, there was high demand for the best form of collateral, US Treasury securities.

Clearly, we want to avoid another financial crisis like the one we had in 2007-2009. Reducing the role of the repo market and a close examination of how it operates would be useful.

Commercial Banks – Raise Bank Capital Ratios and Have Unlimited FDIC Insurance for All Accounts

Generally, the higher a bank’s capital ratio, the lower the probability will be of a bank failure. Raising the required capital ratios for banks effectively lowers the amount of

capital that the government would have to commit to bail out troubled banks in the future.

The current limit on FDIC insurance is \$250,000 per depositor, per FDIC-insured bank, per ownership category. If FDIC insurance were not limited, there would be less incentive for corporations and other organizations to transfer funds from their bank to other financial alternatives such as the repo market.

The FDIC effectively provides unlimited insurance now as its policy is to arrange an acquisition of a weak or failing bank by another bank with a stronger financial position. Such acquisitions are usually accompanied by FDIC guarantees for the acquiring bank to limit losses on the loan portfolios of the acquired bank.

Simplify the Corporate Tax Code and Have Profitable Companies Pay Taxes

The Center for Public Integrity published an article that listed major companies that reported profits on their public financial statements but paid no taxes or received a tax rebate. At the top of the list was Amazon.com which had \$10.8 billion of US pre-tax income and a negative federal tax liability of \$-129 million. See the following article for a list of companies that reported substantial profits in 2018 but paid no federal income tax. <https://publicintegrity.org/inequality-poverty-opportunity/taxes/trumps-tax-cuts/you-paid-taxes-these-corporations-didnt/>

In the United States, there are several sources of differences between tax reports and financial reports. For capital intensive businesses, the largest difference is accelerated depreciation. It is difficult to explain to many Americans why their household pays more in taxes than Amazon. A careful examination of corporate taxation seems to be in order.

Set Some Limits on Corporate Leverage and Share Buybacks

In my blog entry of May 2019 titled “The New Game in Corporate Finance,” I illustrated how some companies have aggressively replaced shareholders’ capital with debt and used the debt proceeds to buyback shares. The companies that were highlighted were

Apple, Boeing, AutoZone, and Domino's Pizza. Boeing now has negative shareholders' equity after several quarters with poor financial results, raising the possibility of government financial assistance.

American Airlines adopted aggressive financial policies and now has negative shareholders' equity. It is seeking government financial assistance as well.

Some companies have borrowed money and used the proceeds to buyback shares. Corporate executives and Board Directors of companies are usually incentivized with stock options and the share buyback programs provide a source of demand for the shares which usually elevates the stock price. The negative impact of such programs is that it can leave the companies in a financially vulnerable position due to weak balance sheets. Negative financial surprises can lead to layoffs or the permanent loss of capital for investors.

There should be some limits set to avoid excessive corporate leverage. Some examples of restrictions could be:

- Eliminate deductibility of interest expense for companies that have negative shareholders' equity.
- Prohibit the payment of dividends or the issuance of stock options for companies that have negative shareholders' equity or fail to meet certain financial ratios.

Operate the Federal Government at a Sustainable Level

For the fiscal year ending September 30, 2020, the US federal budget deficit is expected to be about \$3.3 trillion or about 15% of GDP. The prior budget deficit record was set in fiscal year 2009 at 9.8% of GDP. Federal debt outstanding is now at \$26.7 trillion. The tolerance level for large federal budget deficits and debt outstanding has grown over the years. There always seems to be a justification for it.

There are many examples of countries that let their government debt level get out of control. The usual scenario is that their central banks buy the government debt in large quantities because private investors will not. This leads to excessive fiat money creation, resulting in higher inflation, if not hyperinflation. The higher inflation results in higher interest rates and some lenders may withdraw from the financial markets because few are willing to lend at fixed rates if they anticipate that inflation and interest

rates will continue to accelerate. Hyperinflation and government defaults cause much economic friction. It is not a pretty economic picture.

Members of Congress and the Presidents (past, current, and future?) seem to be oblivious to economic history. It is time to begin the conversation about the necessity for fiscal responsibility of the US Government.