Does (De)regulation Matter in Financial Crises? Examining the Obama Administration's New Bank Plan

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Abstract: The fact that financial crises have happened with regular intervals and probably will happen in the future in much the same way has attracted great attention on the dynamics of crises from scholars as well as policy makers, and causes and remedies have been intensively discussed in the literature. Some have argued that deregulation of financial markets have significantly contributed to the recent crises, and thus they very much favor for sound regulation on financial markets, especially on big investment banks. Conversely, the other view strongly disfavors the aforementioned vision, and supports the liberal idea that the state should not intervene the market with any tool including the regulation. The objective of this study is to analyze the dynamics of the recent crises, investigate their causes, and discuss whether the states can be held responsible against them in the sense of (de)regulating the markets and ensuring the stability of the system. As a case study, the Obama administration's new bank plan is examined to shed lights on the current discussion.

Key words: Financial crisis, (de)regulation, Obama's new bank plan

Introduction

The recent financial crisis has been widely acknowledged as the most serious one since the Great Depression and thus world financial system, and particularly the world banking system, has been affected as bad as any since the stock market crashes of 1929. Accordingly, banking systems in many countries have suffered from an impaired ability to play their vital role in credit extension to the real economy. Despite the fact that the world political and financial systems, particularly US system, have been tilted in favor of business deregulation and against new rules, the recent global financial crisis that has negatively affected almost whole society has somehow changed the thoughts. Now, governments all over the world, especially the US government, have been forced to intervene in the highflying financial industry to avert an economy-wide crash, which will typically result in an expansion of the government's role in financial markets. Obviously, if not directly entering the market, the government's role in financial markets means more regulations. In other words, the new popular motto is regulation in deregulation out. Needless to say that new regulations should not ignore important concepts like efficiency and effectiveness.

It is a well-known fact that financial markets, especially banks, are subject to more developed regulatory mechanisms than other sectors of the economy in order to safeguard the public's savings, bring stability to the financial system, and prevent abuse of financial service customers. In fact, banks lie at the heart of the world's financial system and have indispensable functions in business life. In addition, banks play crucial role in the economic life of the nations. The economic performance of the nations, thus, is strongly related to the soundness of their banking systems. Although banks create no new wealth, their borrowing, lending, and related activities facilitate the process of production, distribution, exchange and consumption of wealth. Consequently, banks are considered as one of the building blocks of the nations' economic development.

No need to mention that the size, variety and characteristics of financial transactions may produce awfully harmful effects on the entire economic system, which justify the more developed regulatory and supervisory regime of the banks and financial institutions, with the explicit objective of ensuring the soundness and stability of the system. There are countless examples of how weak or incomplete regulatory mechanism of banks and financial institutions has created dramatic financial, economic, and social problems. However, regulation is still an unpleasant word on many people's eye, especially on managers and stockholders, who often see the rules imposed upon them by the governments as costly, burdensome, and unreasonably damaging to innovation and efficiency. This state of mind with help of some popular concepts of economics and finance, like freedom, efficiency, international competition and economies of scale, gained momentum in 1980's, and the rules of the game in financial arena rather changed in 1990's; more and more financial service regulations were set aside or weakened, and free market place, not government dictation, was relied upon to shape and restrain what financial firms could do. A well-known example is the 1999 Gramm-Leach-Bliley Act, also known as Financial Services Modernization Act. This act removed the regulatory walls of the Glass-Steagall Act, which is an important legislation from the Great Depression era that imposed a number of regulations on financial institutions like separating banking from security trading, underwriting and insurance industry.

The objective of this study is to analyze the dynamics of the recent crises, investigate their causes, and discuss whether the states can be held responsible against them in the sense of (de)regulating the markets and ensuring the stability of the system. The remaining part of the paper is as follows: The section 2 briefly discusses the causes and characteristics of the recent crisis. In the third section, bailout debate is presented. The forth section investigates the regulation-deregulation discussion. The Obama's bank plan is scrutinized in the fifth section. Finally, the final section provides concluding remarks.

The Recent Financial Crisis: Causes and Characteristics

The financial crisis began in early 2006 when the sub-prime mortgage market in the U.S. began to show an increasing rate of mortgage defaults. In late 2006, these defaults led to a decline in US housing prices after nearly a decade of remarkably high growth. By late 2007, the prime mortgage markets were showing higher than normal default rates. Collateralized Mortgage Obligations (CMOs), a type of collateralized debt obligations (CDOs), allowed these problems to spread from the mortgage market to other sectors of the economy, having especially widespread effects on financial markets as a whole. CMOs were mortgage-backed securities issued by investment banks and other financial institutions, which since they were not part of the commercial banking system, were allowed to operate unregulated by the federal government. As the value of mortgages fell owing to increasing default rates, the value of these securities fell as well.

The risk significantly increased in the early 2000s as sub-prime loans became the primary mortgage used in securitization. As the housing bubble deflated, many portfolios of these securities fell below book value. Since the big investment banks and large hedge funds were allowed to borrow excessively on the huge margin described in the previous paragraph, the drop in value due to mark to market accounting forced the investment banks to write down the value of the security or portfolio as a defensive measure against even greater losses. The rapid drop in value of securitized assets also forced margin calls as some hedge funds, for example, did not have sufficient additional collateral to protect against the margin call. Creditors who lent money to investment banks required certain margin and capital ratios and refused to extend additional credit to funds or investment banks as the value of their assets dwindled. This is what happened to Bear Stearns, which had to be taken over by JP Morgan with the assistance of the government and to Lehman Brothers, which was forced into bankruptcy. It is also what forced Merrill Lynch to merge with Bank of America and Goldman Sachs and Citigroup to cease to exist as Investment Banks.

The credit crisis dramatically collapsed the market cap values of many of the key players in the mortgage industry (whether they made risky loans or not) and in the investment banking community which had successfully securitized all forms of credit for so long. As the table 1 illustrates, investors in these stocks lost over $1 trillion of market cap value (these stocks dropped 92% from their mid 2000 value) as a result of the mortgage securitization process based on securitizing risky loans and allowing excessive leverage to acquire such assets.

Mortgage Companies	Mid 2000s			Mar-09		
Company	Price	Shares (mil.)	Mkt Cap (mil.)	Price	Mkt Cap (mil.)	Notes
Fannie Mae	$80	1000	$80,000	$0.40	$400	Government conservatorship
Freddie Mac	$50	1400	$70,000	$0.17	$238	Government conservatorship
Washington Mutual	$45	1700	$76,500	$0.05	$85	Bankruptcy banking ops sold to J P Morgan Chase
Countrywide Financial	$52	580	$30,160	$6.00	$3,480	Acquired by Bank of America
New Century Financial Corp.	-	-	$1,750	-	$55	Bankruptcy
Investment Banks	Mid 2000s			Mar-09		
Goldman Sachs Group	$240	460	$110,400	$100	$46,000	No longer an investment bank
Bear Stearns Companies	$133	135	$17,955	$2.00	$270	Acquired by J P Morgan Chase
Citigroup	$52	5450	$283,400	$2.00	$10,900	No longer an investment bank
Merrill Lynch	$92	2000	$184,000	$6.00	$12,000	Acquired by Bank of America
Lehman Brothers	$60	689	$41,340	$0.04	$28	Bankruptcy
Other Financial Institutions	Mid 2000s			Mar-09		
Bank of America	$52	5000	$260,000	$6.00	$30,000	Received $45B in bailout funds
American International Group	$72	2500	$180,000	$0.35	$875	Received $180 bln in bailout funds
Combined Mkt Cap of Above Financial Institutions	-	-	$1,335,505	-	$104,331	$1.2 Trillion in Mkt Cap Lost

Table 1: The Market Capitals of Major Companies Before and After 2008 Crisis
Source: http://www.wikinvest.com

The problem was augmented by the Credit Default Swap (CDS). CDSs were nominally insurance contracts on CMOs, but they became a tangled web, which dragged the financial system down as sellers of CDSs bought matching CDSs to protect themselves against default risk until nearly all the players in the investment banking market were linked together by these liabilities. Thus, these CMOs and CDSs became the infamous "toxic assets". The defaults in the mortgage markets caused a collapse in the value of the corresponding CMOs, which created a cascade of additional problems as the multitude of CDSs were executed, dragging down the balance sheets of the major players in investment banking. This led to the freezing of private credit markets. Finally, the collapse in value of CMOs lead to a significant problem: since no one was trading CMOs, it was no longer clear what they were worth. The fact that the financial system is based on trust, the evaporation of trust meant that no private financial institution was willing to lend its scarce cash to any other since the former couldn't trust that the latter was correctly revealing the extent of its CMO holdings, and neither could be sure what those holdings were worth.

These liquidity problems turned to insolvency in September of 2008, when private lending froze completely in a number of important credit markets, such as commercial paper. As a result, non-financial businesses were unable to get access to the financing they required to function normally, leading to problems in the real economy.

The real economy began to exhibit problems related to the financial crisis as early as March 2006, when investment expenditure on residential structures began to decline. In early 2008, this decline spread to investment in business equipment and consumer spending on durable goods. It wasn't until the summer of 2008 that consumer spending broadly and GDP began falling, signs of a recession. In December 2008, the National Bureau of Economic Research, official arbiter of business cycles dated the formal beginning of the recession as December 2007. While the public had been concerned about recession for much of the year, it wasn't until the fall that the economy began to decline at more than a 6% annual rate. Congress responded by passing the TARP plan to assist failing financial institutions. This plan was meant to decrease the severity of the recession by treating its cause: the financial crisis.

The financial crisis and recession in the U.S. spread globally through both financial and trade linkages. Seeing housing prices in the U.S. rising, foreign banks sought opportunities to invest in the U.S. housing market, such as through CMOs issued by investment banks. When the mortgages backing these securities began to fall in value, the value of the securities themselves began to fall. Seeing their asset prices falling, investors attempted to liquidate their holdings beginning in August of 2007. These assets became frozen because of a lack of buyers in the market. As credit became scarce and in response to a lack of confidence in U.S. financial institutions, international banks began to raise the interest rate at which they lent money to one another, known as the LIBOR.

Additionally, the economic slowdown in the U.S. led to declining U.S. imports from its major trading partners, the European Union, Mexico and China. When export sales languished, foreign GDPs fell too, spreading the recession worldwide. Despite recent claims that the US is no longer the locomotive of the world economy, the current crisis shows those claims to be false.

To summarize the origins of the recent financial crisis step by step[28];

- Banks and thrift institutions make mortgages, loans with a piece of real estate as collateral. Mortgages can be sold on a secondary market.
- Corporations such as Freddie Mac and Fannie Mae were set up in the 1930s to create a secondary market in mortgages. They would buy mortgages from the banks, then package multiple mortgages and sell them to other lenders, these packages are called, "mortgage backed securities."
- The root of the current financial crisis were "mortgage backed securities." Bundles of "mortgage backed securities" were known as Collateralized debt obligations were also placed on the market
- Along with low interest rates and rising house prices, banks and other lenders began making loans to riskier borrowers and requiring less equity from borrowers. The "risk" of these loans could be diversified by bundling many loans in the "mortgage backed securities
- When housing prices began falling the summer of 2007, lenders worried about the credit worthiness of the loans in the bundles they held.
- As people began worrying about the credibility of the mortgage backed securities, the price of those bonds fell and interest rates rose. Individuals and institutions who held these bonds thought it was easy to liquidate, but found that they could do so at a loss. Further selling only depressed the price more.
- Investment banks including banks and mortgage lenders were more involved in the creation of the "mortgage crisis securities." Many investment banks retained some interest in these assets because they were also involved in debt servicing.
- In the summer of 2007, the investment banks were under pressure, and their attempts to obtain liquidity by selling assets made the crisis worse.
- A new kind of financial instrument, the Credit Default Swap, played a major role in the crisis in 2008. This new instrument is an insurance policy against bond default. Just like "mortgage backed securities", the assets being traded were not uniform, nor was the prices of these assets was visible to all the traders.
- When investment banks and insurance companies such as AIG had large positions in Credit Default Swap, came under pressure, and the bond prices started falling. Some Credit Default Swaps required the insurer to make partial compensation to the policy owners.
- The uncertainty over the net position and liabilities of the investment banks brought several of them down. The buyers had the incentives to understand the risk of the underlying assets, but was caught up in the bubble mentality, others saw large profits and wanted to get in on the action

Bailout Discussions

In consequence of the 2008 financial crisis, several giant financial firms failed and, as expected, they claimed the government bailout. Even though there was a strong public opposition to the failed firms' bailout call, the US government bailed them out with little exception.

28 http://www.sourcewatch.org

As a result, taxpayers have had to foot a huge bill to save the nation's debt-ridden banks because the government and pro-bailout people claimed that if those failed financial institutions were not saved, then the economy could collapse. They, furthermore, have argued that if there are losses to be covered and it is a matter of saving the financial system from collapse, then taxpayers do have to pay and always have done. They implicitly send message to the taxpayers by saying that if you want the financial system to collapse, you do not bailout anybody. If the system collapses, everybody will suffer and the economy will face a serious depression, which definitely creates more catastrophes then the bailout.

Nearly two year has passed since Congress and former President Bush gave the Treasury Department the authority to distribute hundreds of billions of taxpayer dollars to failed banks, automakers, and AIG. Treasury gave money to more than 700 companies, but a handful of firms received Troubled Asset Relief Program (TARP) money in especially massive amounts. On the other hand, Congress neither specified how the money must be spent, nor dictated how the money must be used by aided institutions (e.g., not to pay CEO bonuses), nor imposed any system of checks and balances. As some people predict, banks may be using the bailout money to advance their own self-interest (they are, after all, for profit entities) rather than to thaw the credit freeze since there is no any system of checks and balances as mentioned above.

Under what conditions would multi-billion-dollar bailouts of private businesses be acceptable? What are the criteria that would be used for deciding when it is prudent to use public money to save private business? It is possible to ask more questions like those. They are obviously terrific questions with no obvious common answers. Different group of people can answer the above questions, however they possibly cannot satisfy others. Even the other people can claim that the answers and/or justifications are biased and cannot help the economy at all especially in the long term.

While researchers, academics as well as practitioners were still discussing the recent financial crisis and bailout issues, the big banks in the US announced that they made large profits and handed out huge bonuses only a year after one of the biggest banking crises and bailouts in the history. Thus, thousands of top traders and bankers on Wall Street were awarded huge bonuses and pay packages, even as their employers were battered by the financial crisis.

CORP.	YEAR	WHAT HAPPENED	COST
Bear Stearns	2008	JP Morgan Chase and the federal government bailed out Bear Stearns when the financial giant neared collapse. JP Morgan purchased Bear Stearns for $236 million; the Federal Reserve provided a $30 billion credit line to ensure the sale could move forward.	$30 billion
Fannie Mae / Freddie Mac	2008	On Sep. 7, 2008, Fannie and Freddie were essentially nationalized: placed under the conservatorship of the Federal Housing Finance Agency. Under the terms of the rescue, the Treasury has invested billions to cover the companies' losses. Initially, Treasury Secretary Hank Paulson put a ceiling of $100 billion for investments in each company. In February, Tim Geithner raised it to $200 billion. The money was authorized by the Housing and Economic Recovery Act of 2008.	$400 billion
(A.I.G.)	2008	On four separate occasions, the government has offered aid to AIG to keep it from collapsing, rising from an initial $85 billion credit line from the Federal Reserve to a combined $180 billion effort between the Treasury ($70 billion) and Fed ($110 billion). ($40 billion of the Treasury's commitment is also included in the TARP total.)	$180 billion
Auto Industry	2008	In late September 2008, Congress approved a more than $630 billion spending bill, which included a measure for $25 billion in loans to the auto industry. These low-interest loans are intended to aid the industry in its push to build more fuel-efficient, environmentally-friendly vehicles. The Detroit 3 -- General Motors, Ford and Chrysler -- will be the primary beneficiaries.	$25 billion
Troubled Asset Relief Program	2008	In October 2008, Congress passed the Emergency Economic Stabilization Act, which authorized the Treasury Department to spend $700 billion to combat the financial crisis. Treasury has been doling out the money via an alphabet soup of different programs. Here's our running tally of companies getting TARP funds.	$700 billion
Citigroup	2008	Citigroup received a $25 billion investment through the TARP in October and another $20 billion in November. (That $45 billion is also included in the TARP total.) Additional aid has come in the form of government guarantees to limit losses from a $301 billion pool of toxic assets. In addition to the Treasury's $5 billion commitment, the FDIC has committed $10 billion and the Federal Reserve up to about $220 billion.	$280 billion
Bank of America	2009	Bank of America has received $45 billion through the TARP, which includes $10 billion originally meant for Merrill Lynch. (That $45 billion is also included in the TARP total.) In addition, the government has made guarantees to limit losses from a $118 billion pool of troubled assets. In addition to the Treasury's $7.5 billion commitment, the FDIC has committed $2.5 billion and the Federal Reserve up to $87.2 billion.	$142.2 billion

Table 2: The major bailouts in 2008 and 2009
http://www.propublica.org/special/government-bailouts

This has unavoidably attracted much criticism given how instrumental the banks were in causing the crisis. It is obviously immoral and insincere: *If they win, they walk away with the profits; if they lose, the taxpayer picks up the tab*. Consequently, this picture beyond doubt created widespread public anger against Wall Street bankers.

A report[29], released by Andrew M. Cuomo, the New York attorney general, provides a little more details about the bailouts. The report confirms that nine of the financial firms that were among the largest recipients of federal bailout money paid about 5,000 of their traders and bankers bonuses of more than $1 million apiece for 2008. For instance, bonuses of more than $1 million went to 953 traders and bankers at Goldman Sachs, while Morgan Stanley awarded seven-figure bonuses to 428 employees. Even though they are weaker banks, Citigroup and Bank of America distributed million-dollar bonuses to hundreds of their workers.

Thus, many people raised their voice by saying, *"risk is being socialized, yet profits are privatized."* That means the rich elite makes money at the expense of the taxpayers. That is completely unfair and not what it should be.

It is morally revolting that the architects of the crisis had huge bonuses only a year after being bailed out by the taxpayer. With large profits made by the banking industry allowing the payment of the massive bonuses, it not just created widespread public anger as mentioned above, but also justified the argument that the new regulation for the banking industry is must. Thus, it has become obviously necessary to regulate the banking industry in such a way that excessive risk taking becomes not possible.

Deregulation in Financial Market

Financial regulation is a form of supervision, which subjects financial institutions to certain requirements, restrictions and guidelines, and aims to maintain the integrity of the financial system. As Warren Buffet noted, ‘Credit Default Swaps are the financial weapons of mass destruction’ (The Economist, September 2008**).** However, shadow banking and credit default swaps (CDSs), allowing betting instruments, remained unregulated.

The lack of regulation of credit default swaps and the shadow-banking sector caused the financial system to grow larger, even more insolvent, and even more unstable. As noted, CDSs were initially used to transfer the risk on a bond onto someone else, but the deliberate lack of oversight meant traders could use these insurance-type contracts to place bets on bonds they did not own; eventually this led to the selling of the insurance contracts themselves when demand became high.. The CDS market grew enormously, but the lack of regulation allowed the gambling on insurance contracts to spiral out of control, until it consisted of more ‘bet money’ than actual bonds. The market eventually came to encompass $60 trillion of bets on bonds, while only $5 trillion worth of bond money was circulating. This meant certain companies were promising billions of dollars in the form of protection that they did not have. American Insurance Group **(**AIG), for instance, owed over $400 billion worth of CDSs that it could not produce, necessitating its bailout by the US government. In addition, the non-regulation of CDSs and shadow banks allowed CDS deals to be made in private, generating in turn a lack of transparency extending to the finances of anyone vested in the market and obscuring the stability of transactions and of finances in general (Stiglitz, 2009). When the crisis hit and the extent of the opacity became apparent, confidence plummeted and credit froze, and because of the market’s interconnectedness, the failure of one bank meant the demise of them all. The taxpayer would ultimately pay for these mistakes through the government bailout of the fallen institutions.

Had hedge funds and investment banks been required to hold proper reserves to back the CDSs with liquid assets, the financial crisis would likely not have reached the level it did. Such regulatory measures would have prevented companies from taking the significant risks that have characterized finance in the 1990s and early twenty-first century, and the CDS market would not have been likely to ‘balloon’ as it did in the first place (Blumberg 2008).

The non-regulation of CDSs and America’s shadow banking sector during the decade leading up to the global crisis was therefore an occurrence that could have been avoided. US policymakers and regulators had ample warning that unregulated CDSs and bank-like institutions would undermine the system’s credibility, and cause a global financial calamity.

Obama's Bank Plan

In response to the distress and turmoil created by the financial firms and banks, the Obama administration proposed a two-part plan regulation, suggesting the comprehensive changes to the financial sector regulation.

29 http://www.nytimes.com/2009/07/31/business/31pay.html

President Obama first proposed a new tax or fee on the 50 largest U.S. financial institutions related to the costs of the government bailout of the financial industry. The idea is to discourage excessive risk-taking, to re-balance a tilted playing field and to generate needed revenue. The fee is expected to raise $90 billion over the next 10 years, and $117 billion over about 12 years. Although the tax would be imposed on 50 largest banks, insurance companies and large broker-dealers, roughly 60% of the revenue is expected to come from the 10 largest financial firms. If approved by lawmakers, the fee would go into effect June 30, 2010 and last at least 10 years. It would amount to 0.15% of total assets minus high-quality capital, such as common stock, and disclosed and retained earnings.

Yet even if Congress goes along with this fee proposal, it will practically not be enough. Because the executives who run these institutions are likely to force shareholders to bear the burden of the tax, while they just keep on much as before. In fact, shareholders have already suffered as the executives undertook mergers, paid out bonuses and took other actions that have diminished shareholder value. Moreover, a new tax would probably give the bankers one more excuse not to restart lending.

Mr. Obama made a second and more direct proposal by adapting the ideas of Paul Volcker, the former Fed chairman, on 22nd of January, 2010. This regulation restricts banks from making investments that are not intended to benefit customers, which is known as proprietary trading. Mr. Obama's new proposal put new limits mainly on the *size* and *activities* of the largest banks by intending to toughen existing limits on the size of financial firms and force them to choose between the protection of the government's safety net and the often-lucrative business of trading for their own accounts or owning hedge funds or private-equity funds. Mr. Obama highlighted this point by saying, *"Never again will the American taxpayer be held hostage by a bank that is too big to fail."*

The second proposal focused on two points.

The first concerns restrictions on the scope of activities. In the case of having insured deposits, and hence accessing to emergency funds from the central bank, the banks would not be allowed to own or invest in private equity or hedge funds nor would they be able to engage in “proprietary” trading though they could continue to offer investment banking for clients, such as underwriting securities, making markets and advising on mergers.

The second focuses on size. Banks already face a 10% cap on national market share of deposits. This would be updated to include other liabilities, namely wholesale funding. The aim is to limit concentration, which has increased greatly over the past 20 years, accelerating during the crisis as healthy banks bought sick ones. The four largest banks now hold more than half of the industry’s assets.

This second proposal is easily considered as, at least, seeking to return the "spirit of Glass-Steagall Act" and will for sure impede the growth of the largest banks and bar them from making what Mr. Obama called "reckless" investments.

Citibank's merge with Travelers Group in 1998 had been seen as a violation of the Bank Holding Company Act (BHCA), and Citibank had thus been given two-year forbearance. Following the GLB act, however, not Citigroup/Traveler Group merger just became legal but several new mergers also took place.

This is an undeniable fact that the repeal of important portions of the Glass-Steagall Act made banks seek high returns by investing money from checking and savings accounts into "creative" and "innovative" financial instruments such as collateralized debt obligations (CDOs), mortgage-backed securities (MBSs) and credit default swaps (CDSs). These risky investments have been blamed to be caused to the collapse of the financial markets in 2008 and the resulting global financial crisis.

The original idea of freeing up the banks or justification of the GLB act was to allow the US banks to compete at the national and international scale especially with European banks. However, many US banks engaged in very aggressive and riskier investments seeking higher returns following the GLB act. These aggressive behaviors were amplified as banking companies grew more complicated, drawing funding from more sources and investing in a wider range of activities. Increasingly, some investments were made to profit the firms' employees and shareholders, which are unrelated to the needs of customers. Those banks had been making increasingly massive profits until the bubble burst in 2008. Although the impetus for the climb in profitability primarily came from the investment banking activities, the key area of growth was in securities with especially mortgage assets. Furthermore, the banks’ activities had been increasingly funded from the wholesale market by lending between banks on narrow margins and not the traditional depositor base in the commercial part of the banks’ business. The problem was not truly recognized before 2008. When the bubble burst, it became not just obvious how risky these activities had been but the enormous scale of securitization combined with high leverage also almost led to a collapse of the whole financial system. In fact, being derivative products there were many third parties that had significant exposure to asset-backed securities

(ABS). Consequently, the investment activities of those banks, aggressively seeking higher profits and market share regardless of the risk, pervaded the whole economy.

Another bill, known as the Commodity Futures Modernization (CFM) Act, had been passed just a year after the GLB Act. I do not think it is false that those two acts together undoubtedly contributed to the 2008 crisis. The (CFM) act unleashed the derivatives market and paved the way for banks to become more aggressive about investing in mortgages. This is basically how it ended up with the largest banks filled with toxic assets, off-balance sheet commitments, and in-house hedge funds among other "investments."

Concluding Remarks

As it is known, commercial banks function as intermediary between depositor and borrower and provide the loans and services to households and companies that are the life-blood of business activity and job creation. Investment banks, by contrast, have often engaged in activities that are more intensive use of complex instruments subject to high-risk volatility, and invested bank capital in hedge funds and private equity firms, which are in high return-high risk category. Nobody has problem with hedge funds and other speculative clubs, so long as they are not risking taxpayer money, whether directly like Fannie and Freddie or indirectly by threatening to bring down the system.

The recent financial crisis has provided a clear lesson against allowing excess leverage and risk-taking through financial innovations that do not correspond to corporate and retail customers' banking needs. In retrospect, one can trace the origins of the crisis to a shift over time away from the 'credit culture' of commercial banking towards an 'equity culture' focused on generating profits for shareholders and management by exploiting new financial innovations and leveraging them while taking advantage of regulatory and tax loopholes. Therefore, as proposed in Mr. Obama's plan, separating these from mainstream activities like deposit-taking and lending, as well as some investment banking activities that correspond to customer needs, such as underwriting, market-making, broking and some derivatives services, could definitely bring important benefits for commercial banking. The separation could notably decrease contagion and counterparty risks, and help sustainable growth by focusing management attention on the core needs of bank clients without major distractions and disruptions.

As Acharya (2009) claims, the goal of bank regulation is to restrain systemic risk rather than the individual risk of institutions. Accordingly, imposing a fee especially on the largest financial institutions, both for their expected losses when individual institution's failure and for expected losses when whole market's failure in the case of the financial system as a whole becomes undercapitalized, minimizes the systemic risk, thus suggest a solution, possibly good and efficient solution. As a consequence, even though it may have some possible flaws, given this framework for regulating systemic risk, Mr. Obama's proposal of imposing a fee against systemic risk of institutions is not just fair on the eye of public but also makes true economic sense.

Moreover, again even though there are some concerns, separating commercial banking and other forms of financial intermediation from proprietary trading definitely limit systemic risk without affecting financial sector's ability to function its core activities.

Obviously, one can easily count several points that need to be fixed and raise some concerns with Mr. Obama's new bank plan. On balance, however, both, a fee against systemic risk and scope restrictions, deserve a serious consideration and seem to be right steps in the right direction. The plan will help creating a sound and more reliable financial system and separating core commercial banking from some higher-risk activities in financial conglomerates and placing a moratorium on further consolidation could help to avoid the new financial crises by resolving some major risks inherent to the current financial system.

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