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Nothing's changed since crisis

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Stuart Theobald : Bankers have not seen much of the regulatory battles they were expecting to face

SEE YOU IN COURT: The Security Police and Fire Professionals of America Retirement Fund has sued Goldman Sachs, saying the investment bank's board breached its fiduciary duties by awarding employees $16.7-billion in bonuses, and did not act in the best interests of the company and its shareholders Pictures: REUTERS
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BUSINESS AS USUAL: Traders in the Goldman Sachs booth on the New York Stock Exchange
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We are at the end of the second year since the financial crisis hit. What is perhaps most remarkable is how little has changed. In this column a year ago, I pointed to the likely raft of regulations that would befall the banking industry, inducing big changes to the business model of banking and financial markets. That has not happened - not here, but more importantly, not anywhere.

While bankers - those in South Africa included - have had a tough 2009 from a business point of view, the regulatory battles they were expecting to face have been rather light.

Compare that to the post-Enron regulatory backlash when, within six months, the Sarbanes-Oxley Act had been signed into law, affecting the accounting world's regulatory architecture.

Perhaps it is because Sarbanes-Oxley went too far that legislators have been slow to introduce new laws following the financial crisis. About the only area to receive much focus is bankers' salaries and bonuses - an area done more for the public sport than the systemic importance. In the trickier issues around banks' use of capital and the types of instruments they can buy and sell, where the heart of the crisis really lay, very little has been said, apart from vague promises to "be tougher".

Bank bailouts are a key issue - the massive use of public funds to keep banks that are "too big to fail" alive. One would have expected, a year after the US government pumped one trillion dollars into the economy (by one measure, equivalent to R25000 per US citizen), many people would be thinking about how to avoid doing it again. Surely, with bankers well aware that a government-sponsored safety net is available when needed, it is a question of when, not if, they fall into it again.

Each day that goes by, one senses a loss in political will to tackle issues in the global financial system that allowed the crisis to grow. The sense of disaster has passed, and with it the opportunities to make dramatic changes, such as slicing up the mega banks into pieces that would be easier to regulate and, if it were ever needed, to shut down. I don't know whether that would have been a good idea, but we've lost the chance to do it even if it was.

Instead, we are left with less dramatic options. The challenge now is to find ones that will be effective in ensuring the financial system does not find itself in such a pickle again. The Bank for International Settlements, which is the key mover in the Basel Committee that makes international rules for bank capital management, is working hard to come up with new ideas to make banks less risk averse. It will be implementing some of those next year, specifying greater levels of capital for banks that engage in certain types of activities. Capital is shareholder's money, and if the banks have to hold more of it, it means the shareholders get less return on their cash. As a result, they are likely to want banks to steer away from the business practices that Basel determines to be of a greater capital appetite.

But such a move requires blow-by-blow assessments of banks' activities. Markets tend to work much better when there are general rules applied, rather than specific product lines or instruments that are targeted, spawning clever ideas for new instruments that get around the rules.

One interesting suggestion, made by the Cato Institute's William Poole in a recent Financial Analysts Journal article, is to change the tax status of interest. One problem that led to the financial crisis is the difference between the cost of debt and the cost of equity. Those are the two sources of funding that any company has access to - equity is money from shareholders, while debt is money from lenders, usually banks. The more debt there is, the greater the riskiness of the company, because it always has to pay interest but in tough times shareholders can go without their dividends. If you want to decrease risk in an economy, you want to have more equity around and less debt. That's what the Basel Committee will do to banks - but the riskiness of an economy extends beyond banks to every borrower in it.

So here's the proposal: end the tax deductibility of interest. At the moment, when a company pays out dividends, it is out of after-tax profits and it has to pay an additional 10% dividend tax. But interest payments are far cheaper because they can be made from before-tax profits. This creates a swing in favour of debt in the mix of any company's source of funds, so increasing overall risk. Of course, the change will also raise more tax for the fiscus - much needed right now and certainly less damaging to the economy than an increase in income tax.

Such a change could be phased in over a few years to prevent any shock to the system. With 2010 likely to be a good year for banks, including in South Africa, it will be a good time to float the idea.