AFR Americans for Financial Reform

United States Senate Banking Committee
Dirksen Senate Office Building
Washington, DC 20510

To Whom It May Concern:

On behalf of Americans for Financial Reform, we are writing in response to the Senate Banking Committee's request for proposals to foster and improve economic growth.[1]

Below, we outline several specific proposals in response to the Committee's request. We have focused on selected new proposals which have not yet been introduced as legislation. However, there have also been several pieces of legislation introduced in this Congress that are relevant to the economic growth issues raised in this letter and which we also support and recommend to the attention of members of the Committee:

- S 881, "The 21st Century Glass Steagall Act" introduced by Senators Warren and McCain, would force separation between commercial banking and significant capital markets activities. Only commercial banking activities would remain within the public safety net of regulated banks. We believe that this separation would both reduce the likelihood of economically disastrous financial crises, and would enhance economic growth by reducing opportunities for market manipulation, improving market discipline in the capital markets, and focusing banks on sound underwriting.

- S 82, "The Stop Subsidizing Multimillion Dollar Corporate Bonuses Act", introduced by Senators Reed and Blumenthal, would modify Section 162(m) of the Internal Revenue Code to end the tax deductibility of "incentive pay" compensation to corporate executives that exceeds the cap of $1 million per employee on deductible wage expenses. These incentive pay awards are overwhelmingly stock option awards that add to the problem of "short-termism" and excessive capital markets focus in corporate incentives, which is discussed below in our proposal concerning stock buybacks. Ending this subsidy to stock option awards would properly focus top executive incentives on the long-term well being of all company stakeholders, which would be beneficial to economic growth.

[1] Americans for Financial Reform is an unprecedented coalition of over 250 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, religious and business groups. A list of our members is available at http://ourfinancialsecurity.org/about/our-coalition/

- "The Brokaw Act", introduced in the last Congress as S 2720 by Senators Baldwin and Merkley, would also address the issue of short-termism by improving transparency and oversight of activist hedge funds. The enhanced transparency and disclosure requirements in this legislation would enlist market forces to help prevent cases where hedge funds force companies to make changes that benefit hedge funds at the expense of the company's long term well being.

In addition, we strongly urge the committee to avoid eliminating regulatory measures put in place in response to the 2008 financial crisis in the name of supposed short-term benefits in economic growth. This would be profoundly short sighted. The experience of the Global Financial Crisis vividly demonstrates the damage done by the inadequate regulation of financial institutions and markets. Based on estimates from non-partisan sources such as the Dallas Federal Reserve and the Government Accounting Office, the financial crisis cost from $6 to $15 trillion in lost economic output alone. Any policy that makes such catastrophic economic outcomes more likely in the name of a temporary boost in revenue or profits must be rejected by your committee.

Below we outline four specific proposals:

1) Limit tax advantages for excessive corporate leverage
2) Help Federal Reserve economic interventions reach Main Street more effectively.
3) Encourage investment by restricting manipulative stock buybacks.
4) Reform credit rating agencies to improve capital market efficiency.

1) Limit Tax Advantages For Excessive Corporate Leverage.

The issue: The U.S. tax system provides a very substantial subsidy to debt over equity financing for corporations, due to in large part to the tax deduction for interest expenses. The effect of this subsidy is to encourage corporations to finance growth and investment through leverage, rather than seeking equity investment.[2] These tax provisions also provide an implicit subsidy to debt-financed acquisitions of companies such as those frequently engaged in by private equity firms. In recent years, there have been bipartisan proposals that have proposed limiting or eliminating the interest deduction. For example, the 2011 Wyden-Coats tax plan would have cut back the interest deduction more sharply by basing it on the real interest rate, while the current House Republican tax proposal effectively eliminates the corporate interest deduction.

Reducing incentives to excessive leverage in the corporate sector could have significant benefits for economic growth. Excessive leverage in the financial sector was a major contributor to the financial crisis. Excessive leverage for non-financial corporations, often created by leveraged

[2] Discussion of the nature of this tax subsidy and proposals for reform can be found in the 2011 joint hearings on the tax treatment of debt and equity by the House Ways and Means Committee and the Senate Finance Committee, available at https://www.finance.senate.gov/hearings/tax-reform-and-the-tax-treatment-of-debt-and-equity

acquisition strategies driven by private equity firms, increases the danger of bankruptcy for non-financial firms, with accompanying job loss and economic disruption.[3] Indeed, the most recent IMF Global Financial Stability Report identified excessive leverage in the non-financial corporate sector as a major threat to employment and economic growth should interest rates increase from their current low level.[4]

The proposal: Cap interest deductibility for "thinly capitalized" or excessively indebted companies; place a small fee on the non-deposit leverage of financial companies. There are a wide variety of possibilities for implementing this proposal, many of which have already been put forward in various forms. For non-financial companies, the interest deduction could be disallowed for companies that exceeded a certain ratio of debt to earnings before interest and taxes (EBITDA). For example, debt ratios of leveraged buy-out targets have typically averaged five to six times EBITDA.[5] Such levels would be considered highly leveraged for an ordinary non-financial company. A cap on interest deductions for borrowings that exceed a ratio of three or four times debt to EBITDA, levels that have typically been used by bank examiners to indicate a leveraged loan, would restrain leverage generated by the LBO business model.[6]

Financial companies frequently have leverage ratios higher than non-financial companies, so an interest deductibility cap appropriate for some financial companies such as banks might have to be set at a higher level or through a different mechanism than debt/EBITDA ratios. But another way of counteracting the leverage subsidy for these entities would be to place a small fee on leverage-funded liabilities. A proposal for such a fee applied to large financial entities was advanced by the Treasury Department in 2016 and is detailed in their budget submission.[7]

2) Help Federal Reserve economic interventions reach Main Street more effectively

The issue: The past decade has seen a historically unprecedented use of Federal Reserve monetary and lending policy. During the 2007-2010 period the Federal Reserve made unprecedented use of the emergency lending powers granted to them in Section 13(3) of the Federal Reserve Act. These emergency lending powers were overwhelmingly used to support financial institutions and limit their losses. During and after that period the Federal Reserve also practiced unconventional monetary policy involving large-scale purchases of long term debt. This "quantitative easing" policy lowered long-term interest rates and boosted asset prices.

While these policies had an impact in stabilizing the economy, many have also criticized them

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[3] Appelbaum, Eileen and Rosemary Batt, *Private Equity at Work: When Wall Street Manages Main Street*, Russell Sage Foundation, March, 2014.

[4] International Monetary Fund, *2017 Global Financial Stability Report*: *Getting the Policy Mix Right*, April, 2017, available at https://www.imf.org/en/Publications/GFSR/Issues/2017/03/30/global-financial-stability-report-april-2017

[5] William Blair, "Leveraged Finance Market Update", Spring 2015.

[6] Office of the Comptroller of the Currency, "Leveraged Lending", Comptroller's Handbook, February 2008.

[7] United States Department of the Treasury, "General Explanations of the Department's Fiscal Year 2016 Revenue Proposals", February 2015, US Government Printing Office. Available at https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf

for failing to provide more effectively targeted assistance to areas of the economy most affected by the recession. One notable area that was not effectively targeted was state or local governments under financial stress due to declines in tax revenues connected to the recession. The declines in state and local government employment due to fiscal losses during the recession were significant. State and local employment as a percentage of total population declined from almost 5.5% in 2008 to less than 5.1% in 2014. Had this decline not occurred, 1.3 million jobs would have been saved during the 2008-2014 period.[8]

More broadly, the Federal Reserve policy of quantitative easing (QE) has had some real success in stimulating the economy by reducing long-term interest rates. But questions have been raised about its distributional effects and its targeting on areas of greatest need.[9] Since the policy works through boosting asset prices and by lowering interest rates to facilitate borrowing, it fundamentally operates through the intermediation of Wall Street asset markets and financial institutions. A similar amount of monetary injection into the economy could almost certainly achieve more if it could be more targeted toward directly increasing jobs and buying power among those populations and regions most harmed by economic recession.

Such targeting could be achieved by spending programs of the type typically undertaken through fiscal policy. But during the recession Congress was reluctant to engage in aggressive and sustained fiscal policy, and the Federal Reserve apparently did not feel it had the political freedom or delegated authority to engage in targeted spending programs that went too far beyond its traditional role of creating financial sector liquidity.

In general, despite the unprecedented Federal Reserve assistance, the recession was unusually prolonged and recovery growth rates were slow. This pattern is characteristic of recessions emerging from major financial crises, but it still begs the question of how Federal Reserve assistance can be made more effective. If there is another severe recession, particularly one that occurs when interest rate policy is already close to the lower bound and the Federal Reserve balance sheet is still holding trillions in bonds from recent large-scale asset purchases, this question will become urgent.

Below we offer two proposals that would give the Federal Reserve more options to act against financial crises and recessions in a manner that will better assist overall economic growth.

Proposal #1: Expand and clarify Federal Reserve authority to assist state and local governments: Currently, Section 13(3) of the Federal Reserve Act gives very broad authority to the Federal Reserve to lend to solvent entities during unusual or exigent circumstance, through a program with broad-based eligibility. However, the title of this Section – "Discounts for

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[8] Bureau of Labor Statistics data; AFR calculations.

[9] Montecino, Juan Antonio and Epstein, Gerald, "Did Quantitative Easing Increase Income Inequality?", October 2015, Institute for New Economic Thinking Working Paper Series No. 28. Available at SSRN: https://ssrn.com/abstract=2692637 or http://dx.doi.org/10.2139/ssrn.2692637; Montecino, Juan Antonio and Epstein, Gerald, "Have Large Scale Asset Purchases Increased Bank Profits?", December 1, 2014, Institute for New Economic Thinking Working Paper Series No. 5. Available at SSRN: https://ssrn.com/abstract=2586249 or http://dx.doi.org/10.2139/ssrn.2586249

individuals, partnerships, or corporations" – leaves unclear whether the lending authority includes state and local governments. This should be clarified by changing the title of Section 13(3) to:

"Discounts for individuals, partnerships, corporations, or state and local governments"

Section 14(b)(1) of the Federal Reserve Act also places significant limits on the authority of the Federal Reserve and its member banks to purchase the obligations of state and local governments. This prevents purchases of state and local government debt from being involved in "quantitative easing" strategies and casts doubt on other forms of intervention as well.

Ironically, Section 14(b)(1) places stronger limitations on the purchase of state and local government bonds than it does foreign government bonds, meaning that a Federal Reserve bank could provide credit assistance to a government halfway around the world more easily than it could a local town. The statutory language in Section 14 of the Federal Reserve Act should be changed so as to conform the conditions for lending to an American state or local government with the conditions for lending to a foreign government. This change could be made through the following edits to Section 14(b)(1) – additions are in red, and deletions are struck out:

1. To buy and sell, at home or abroad, bonds and notes of the United States, bonds issued under the provisions of subsection (c) of section 4 of the Home Owners' Loan Act of 1933, as amended, and having maturities from date of purchase of not exceeding six months, and ~~bills, notes, revenue bonds, and warrants with a maturity from date of purchase of not exceeding six months, issued in anticipation of the collection of taxes or in anticipation of the receipt of assured revenues by~~ obligations of, or fully guaranteed as to principal and interest by, any State, county, district, political subdivision, or municipality in the continental United States, including irrigation, drainage and reclamation districts, such purchases to be made in accordance with rules and regulations prescribed by the Board of Governors of the Federal Reserve System, and obligations of, or fully guaranteed as to principal and interest by, a foreign government or agency thereof, such purchases to be made in accordance with rules and regulations prescribed by the Board of Governors of the Federal Reserve System. Notwithstanding any other provision of this chapter, any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to the principal and interest may be bought and sold without regard to maturities but only in the open market.

Proposal #2: Establish a Money-Financed Fiscal Program (MFFP) as a new monetary policy option for the Federal Reserve: As discussed above, if another recession occurs it will be critical to use fiscal policy in addition to monetary policy tools based purely on interest rates, such as large-scale asset purchases or cuts in the discount rate. Yet the recent recession revealed significant barriers to aggressive fiscal policy, despite Federal Reserve warnings that such policy was badly needed.

Former Federal Reserve Chair Ben Bernanke has suggested creating a new monetary policy tool that the Fed could use to facilitate fiscal policy decisions by Congress, which he calls a "Money

Financed Fiscal Program" (MFPP).[10] The MFPP option would permit the Federal Reserve to deposit funds into a new Treasury account, if a suitable majority of Federal Reserve governors felt that additional spending was necessary to reach the statutory full employment goals of the Federal Reserve. Funds in this account would then be available to Congress for fiscal spending. Such spending would not increase the deficit or require government borrowing. The choice of how to spend the funds, or whether to spend them at all, would be completely within the control of Congress.

An MFPP would create what is effectively the best of both worlds. An independent Federal Reserve could use its professional judgement to determine whether additional economic stimulus was necessary in exigent circumstances. Congress could then provide that stimulus through spending programs targeted at the areas of greatest need without increasing the public debt.

The specific design and drafting of an MFPP would require a number of choices that go beyond the scope of this memo. These choices would include:

- The conditions for Federal Reserve deposit of funds into an MFPP account, including the governance mechanism (e.g. whether control was vested in the Fed Open Market Committee, the Board of Governors, or some other committee), the votes required (e.g. majority or supermajority), the economic triggers (e.g. related to full employment mandate, or some other trigger related to more significant economic slowdowns or job losses), and any limitation on amount of funds.

- The procedural mechanisms governing Congressional use of the funds, e.g. whether expedited votes would allowed and whether any ordinary budgetary procedures should apply given that use of the funds would not require issuing debt or adding to the deficit.

While the establishment of an MFPP would not have an impact on economic growth in normal times (since the mechanism would not be used at such times), it would have a powerful impact on growth during major economic downturns such as the 2008-09 recession.

3) Encourage Investment By Restricting Manipulative Stock Buybacks

The issue: The recovery from the Great Recession has been marked by historically high levels of corporate profits but slow overall economic growth and slow employment growth.[11] Corporations have also made use of low interest rates for significant borrowing. But despite being flush with cash from high profits and low interest rates, corporations have failed to use

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[10] Bernanke, Ben, "What Tools Does The Fed Have Left?", Brookings Institution Blog, April 11, 2016. Available at https://www.brookings.edu/blog/ben-bernanke/2016/04/11/what-tools-does-the-fed-have-left-part-3-helicopter-money/

[11] Schwartz, Nelson D, "Recovery In U.S. Is Lifting Profits But Not Adding Jobs", New York Times, March 3, 2013. Available at http://www.nytimes.com/2013/03/04/business/economy/corporate-profits-soar-as-worker-income-limps.html

their funds to significantly increase investment, either in physical capital or in their workers.

There are a number of potential reasons for this, but a prominent contributor appears to be that companies are using their funds for financial engineering strategies aimed at boosting stock prices, rather than for investment. The economist William Lazonick has extensively researched the growth in stock buybacks over the past 15 years, particularly during the recession and recovery, and the impact this is having on investment.[12] Larry Fink, the head of investment giant Blackrock, has also decried the recent growth in stock buybacks as symptomatic of a short-term perspective that robs companies of funds for investment in long-term growth.[13]

With the growth in equity-based incentive pay for corporate executives, such buybacks can massively benefit top company executives through their short-term impact on stock prices. For example, if an executive chooses to exercise their options immediately following a stock buyback they can earn substantially increased compensation as a result of the short-term boost in stock prices following the buyback.

The proposal: End anti-manipulation safe harbors for stock buybacks, and restrict insider sales of stock during the period immediately following a stock buyback. The SEC used to scrutinize stock buy backs for evidence of stock price manipulation, and they were much more unusual at that time, . However, in 1982 the SEC issued Rule 10b-18, which provided a safe harbor from oversight so long as daily stock buybacks did not exceed 25% of average trading volume. This rule is exceptionally generous, both in the size of the buybacks permitted (which can be repeated daily) and the absence of any presumption that even buybacks that exceed the generous provisions in the rule represent manipulation. The 10b-18 rule represents implicit permission for major and repeated stock buybacks. Not surprisingly, buybacks have soared since it was issued and continue to increase today.

The 10b-18 rule should be reversed and the SEC should be required to return buyback rules to their pre-1982 status. If corporations wish to return capital to their investors, they can do so through dividends, which permit direct return of capital without the short-term price effects of stock buybacks.

In addition, rules governing insider sales of stock or exercise of stock options should be modified to ban such sales for a significant period (e.g. a week) after a stock buyback. This would eliminate top executive incentives for stock buybacks based on the potential benefits they may gain in their own compensation packages.[14]

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[12] Lazonick, William, "Profits Without Prosperity", Harvard Business Review, September, 2014. Available at https://hbr.org/2014/09/profits-without-prosperity. Lazonick, Williams, *Stock Buybacks: From Retain-And-Reinvest to Downsize and Distribute*, Center for Effective Public Management, Brookings Institution, April 2015. Available at https://www.brookings.edu/wp-content/uploads/2016/06/lazonick.pdf

[13] Blackrock, *Larry Fink: Annual Letter to CEOs,* January 24, 2017. Available at https://www.blackrock.com/corporate/en-us/investor-relations/larry-fink-ceo-letter

[14] The use of Rule 10b5-1 plans which schedule executive pay in advance is intended to prevent executive trading based on foreknowledge of insider information such as stock buyback dates. However, the effectiveness of such plans in preventing insider trading has come under serious question, and in any case

3) Reform Credit Rating Agencies To Improve Capital Market Efficiency

The issue: Large credit rating agencies such as Moody's and Standard & Poors ("Nationally Recognized Statistical Rating Organizations" or NRSROs) play a crucial economic role. By certifying the investment quality of everything from ordinary corporate debt to complex structured securities, they help to channel trillions of dollars in investment capital to economic end uses. When NRSROs fail to do their job well, economic efficiency is directly impaired..

Unfortunately, recent history has revealed major shortcomings in the operation of NRSROs. The credit rating agencies were central contributors to the financial crisis of 2008. They certified tens of thousands of 'toxic' bonds based on subprime mortgages as high-quality, investment grade assets that were safe to hold for investors and banks. This led to a massive expansion of the mortgage securities market and a major misallocation of capital into housing. The failure of these 'toxic assets' to perform as promised, including the mass downgrades that resulted when their true risks were revealed, was a major trigger of the financial crisis. Extensive evidence demonstrates that the major NRSROs ignored factual information and analytic methods that would have demonstrated that their securities ratings were deeply flawed, and instead catered to issuers by issuing inflated ratings.[15]

The failure of the credit rating agencies to do their job of properly assessing securities risk was rooted in the conflicted incentives they face. Since they are paid by securities issuers, their incentives are to give high ratings that will help the issuers sell their product easily. Credit ratings agencies that apply particularly strict ratings standards can quickly lose business. In contrast, a later failure of rated securities to perform as advertised doesn't appear to have much impact on revenues – just a few years after the financial crisis, ratings agencies were back to making record profits.[16] These incentive issues are particularly significant in the market for complex structured securities, since it is more difficult for investors to perform independent due diligence on these complex products and the large number of structured securities create a significant revenue flow for NRSROs willing to inflate ratings.

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these plans may not protect against timing a buyback to coincide with the pre-arranged sale date for an executive's stock.See e.g. Eaglesham, Jean and Rob Barry, "Trading Plans Under Fire", Wall Street Journal, December 13, 2012. Available at https://www.wsj.com/articles/SB10001424127887324296604578177734024394950

[15] Coffee, John, "Ratings Reform: The Good, The Bad, and The Ugly", Harvard Business Law Review, Volume 1, Number 1, Spring 2011. Available at http://www.hblr.org/wp-content/uploads/2014/09/Ratings-Reform.pdf. United States Department of Justice, *Justice Department and State Partners Secure $1.375 Billion Settlement With S&P*, Office of Public Affairs, February 3, 2015. Available at https://www.justice.gov/opa/pr/justice-department-and-state-partners-secure-1375-billion-settlement-sp-defrauding-investors

[16] Martin, Timothy, "What Crisis? Big Ratings Firms Stronger Than Ever", Wall Street Journal, March 11, 2016. Available at https://www.wsj.com/articles/what-crisis-big-ratings-firms-stronger-than-ever-1457655084

The Dodd-Frank Financial Reform Act required the Securities and Exchange Commission (SEC) to implement supervisory reforms of credit rating agencies in order to prevent conflicts of interest from again having a disastrous impact on rating agency performance. However, as implemented by the SEC, these reforms rely essentially on ratings agency self-regulation policed by SEC inspection, and on disclosure of historical performance.

These changes are highly unlikely to alter the fundamental incentives for ratings inflation faced by ratings agencies under the current business model. This is particularly true since the SEC has been unable or unwilling to act on serious abuses found during its inspection process.[17] There is strong evidence that ratings agencies have already returned to the practice of systemically inflating their ratings of complex securities in order to preserve business from issuers.[18] A recent SEC examination report found that of the three larger NRSROs (who dominate the market), two of them were failing to use quantitative models correctly on numerous occasions and all three lacked key controls over the development of ratings methodologies and models.[19] But the SEC issued no penalties in connection with these findings.

There have been a number of policy recommendations to address these issues. While we would be supportive of a range of possible Congressional actions that improve ratings agency incentives, below we advance a straightforward proposal that would significantly improve the accountability of ratings agencies.

The proposal: Hold NRSROs accountable for their own predictions of performance:
Congress should act to hold ratings agencies accountable for the ratings agencies' own performance predictions. This could be done by imposing costly but temporary sanctions on credit ratings agencies when the performance of rated securities diverges dramatically from the ratings agencies' own predictions of performance. This accountability model involves two steps:

1) First, the SEC should mandate that NRSROs associate each ratings level (e.g. AAA, AA, etc.) in each asset class with a clear quantitative prediction of the probability that the security will default or fail to make timely payments.

[17] Morgenson, Gretchen, "Ratings Agencies Still Coming Up Short Years After the Crisis", New York Times, January 8, 2016. Available at https://www.nytimes.com/2016/01/10/business/ratings-agencies-still-coming-up-short-years-after-crisis.html

[18] Gaillard, Norbert and William J. Harrington, "Efficient, Common Sense Actions To Foster Accurate Credit Ratings", Capital Markets Law Journal, Volume 11, Number 1, January 13, 2016. Available at https://academic.oup.com/cmlj/article-abstract/11/1/38/2366006/Efficient-commonsense-actions-to-foster-accurate

[19] See e.g. p. 11 and pp. 18-20 in Securities and Exchange Commission, *2015 Summary Report Of Commission Staff's Examination of Each Nationally Recognized Statistical Rating Organization,* Office of Credit Ratings, December, 2015. Available at https://www.sec.gov/ocr/reportspubs/special-studies/nrsro-summary-report-2015.pdf

2) If the actual failure rate of a class of rated securities diverges significantly from the performance predicted by the ratings agency itself, the SEC must automatically suspend the ratings agency's license to rate securities in that class for a period of time. During the suspension, the ratings agency could examine and repair its ratings procedures to address the source of the accuracy problem. The inability to rate an asset class for an extended period of time would constitute a significant financial penalty on a ratings agency.

If this procedure was applied in a clear, predictable, and automatic way it would significantly shift ratings agency incentives. An extended period of suspension based on inaccurate ratings predictions would constitute a serious financial penalty for a ratings agency. Looking ahead to this possible sanction creates an up-front incentive for the NRSRO to make accurate predictions.

This sanction would also shift competitive incentives among ratings agencies. Currently, there is little incentive for a ratings agency to diverge from other agencies in making more conservative performance predictions, as it is likely to lose business by doing so. But under this system, an agency that made more conservative predictions could avoid a future suspension of its ability to rate, and could gain market share while less accurate competitors served a period of suspension.

A performance accountability procedure avoids government micro-management of ratings agencies. It only holds ratings agencies accountable for their own predicted outcomes and leaves them free to adopt an appropriate correction when their existing methodology fails. As past failures of ratings agency performance have been unmistakable and egregious, the automatic suspension procedure could be triggered only in cases where ratings failures were very large.

The SEC already has significant administrative authority to enact each of these steps on its own, based on the authority to mandate NRSRO clarity and transparency in ratings symbols included in Section 938(a) of the Dodd-Frank Act, as well as the authority to suspend NRSRO license to rate in Section 932 of the Dodd-Frank Act. But as discussed above the agency has not taken steps to enforce NRSRO accountability. Congress should act and mandate them to do so.

Thank you for your attention to these proposals. Should you have questions, please contact Marcus Stanley, AFR's Policy Director, at 202-466-3672 or marcus@ourfinancialsecurity.org.

Sincerely,

Americans for Financial Reform