



The Second Life of Mr. Volcker:

The shifting ground in banking regulation within the United States

A paper by Stefano PAGLIARI¹,
for the Foundation for European Progressive Studies

February 2010

¹ The author is a Ph.D. Candidate at the University of Waterloo and Visiting Scholar at Initiative for Policy Dialogue, Columbia University. The author would like to thank IPD for the support and Stephany Griffith-Jones for her valuable suggestions.

Given the central role that banks had in the financial turmoil of 2007-09, it is not surprising that banking regulation has been at the centre of the regulatory response to the crisis in Europe, in the US, and internationally since its inception. However, policymakers and commentators have been caught off-guard by the announcement made at the beginning of 2010 by the President Obama of three significant reforms in the regulation of the banking industry. These reforms would: 1) introduce a bank levy, 2) introduce a new cap on size, and 3) prohibiting banks from owning, investing in or sponsoring hedge funds and private equity groups and from engaging in proprietary trading (so-called 'Volcker rule'). These three measures will be analyzed in section 2, 3, and 4 of this short commentary. In order to highlight the significance of these proposals and the change of direction they impress in the international regulatory debates, the next section will summarize instead the regulatory proposals that had dominated the US debate over banking regulation until the end of 2009.

1. Reforming banking regulation in the US until the end of 2009

The three proposals announced by the US administration at the beginning of 2010 have significantly shifted the ground in the debate over the reforms in banking regulation. The priorities of US authorities in the reform of banking regulation had been outlined primarily in two documents presented by the US Treasury between June and September 2009.

First, in June 2009 the US Treasury published an important report entitled "Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation".² At the centre of this document there is the principle that all financial firms that pose a threat to financial stability should receive a different treatment and be subject to heightened regulatory standards. Moreover, systemically relevant firms would also be required to maintain rapid resolution plans, what has come to be known as "living wills". The authority to designate financial companies as systemically significant and to monitor systemic risk would be delegated to a new body comprising the major prudential regulatory agencies and named "Financial Services Oversight Council". Moreover, the US Treasury also emphasized the need to give regulators authority to assume control of a firm threatening the stability of the financial system for the sole purpose of arranging an orderly liquidation or merger, a principle endorsed also by the G20 at the Pittsburgh Summit.

The US Treasury has also announced in September 2009 a reform in the existing capital requirements regime.³ This document established that capital requirements should not focus uniquely on the protection of the solvency of individual banks. Rather this micro-prudential focus should be supplemented by a macro-prudential focus on promoting the stability of the financial system. This macro-prudential focus has informed significant departures from the capital requirements in place

² US Treasury (2009). Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation, Department of the Treasury. June 17

³ US Treasury (2009). Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms Department of the Treasury. September 3

prior to the crisis. While the existing Basel II agreement grants a favorable treatment to the largest and most sophisticated banks, the US Treasury has announced that capital requirements should be higher for systemically relevant financial institutions. Moreover, in line with what already agreed by the Financial Stability Board and the Basel Committee, the US Treasury blueprint seeks to introduce countercyclical elements into the regulatory capital regime and to complement these risk-weighted capital requirements with a non-risk-based cap on leverage and by liquidity requirements.

It is important to notice that these two key set of regulatory measures dealt with the “too big to fail” problem through the introduction of capital requirements and other incentives which would discourage the growth of financial institutions, rather than through limitations of their activities. Instead, the proposals presented by the Obama administration since the beginning of 2010 have taken a different direction.

2. The Financial Crisis Responsibility Fee

The US President Barack Obama has announced at the beginning of January 2010 the “Financial Crisis Responsibility Fee”⁴. This levy is designed to recoup taxpayer funds used during the crisis to bailout financial institutions in trouble while at the same time reducing the risk taking of banks. The proposed levy amount to a fee of 0.15% of bank assets after subtracting Tier 1 capital and deposits insured by the Federal Deposit Insurance Corp. This levy would apply only to the major banks with a balance sheet of more than \$50bn and would end when the bailout costs - which the administration estimates at \$120bn - are recouped. Some analysts have estimated that 60% of the revenue would come from the top 20-30 largest banks, which are expected to pay between \$500m and \$2bn. According to Morgan Stanley analysts the biggest US levies would be charged against Citigroup (\$2.2bn), JPMorgan (\$2.1bn) and Bank of America Merrill Lynch (\$1.9bn).

Because of its structure, the levy will impose a smaller burden on those banks such as Bank of America, Wells Fargo, and JP Morgan Chase, which finance a large part of their balance sheet through retail deposits. By contrast, the levy will place a relatively larger burden on former investment banks such as Goldman Sachs and Morgan Stanley with a small deposit bases relative to assets. A rationale for this discrimination comes from the fact that deposit-taking banks already pay a fee to the Federal Deposit Insurance Corporation to insure their deposits. But this different treatment also reflects the attempt to penalize banks that rely on commercial paper and other form of short-term funding from capital markets and to encourage the reliance on a more stable form of funding such as retail deposits.

It is important to notice that this tax on bank balance sheets would be charged on all big banks operating in the US, including the US operations of a dozen or more European banks which did not

⁴ PRESS RELEASE: “PRESIDENT OBAMA PROPOSES FINANCIAL CRISIS RESPONSIBILITY FEE TO RECOUP EVERY LAST PENNY FOR AMERICAN TAXPAYERS”, 14 JANUARY 2010. AVAILABLE ONLINE AT [HTTP://WWW.WHITEHOUSE.GOV/THE-PRESS-OFFICE/PRESIDENT-OBAMA-PROPOSES-FINANCIAL-CRISIS-RESPONSIBILITY-FEE-RECOUP-EVERY-LAST-PENN](http://www.whitehouse.gov/the-press-office/president-obama-proposes-financial-crisis-responsibility-fee-recoup-every-last-penn)

directly benefit from US government assistance. For instance, analysts at Morgan Stanley estimate that the tax liability would be \$560m for Barclays, \$551m for Deutsche Bank, \$430m for HSBC. For those European banks whose US operations are closer to the \$50bn balance sheet threshold, it could be desirable to reduce their American presence in order to fall below the \$50bn threshold and to avoid the tax.

Since the US President Obama has called for a tax on bank's balance sheet, the debate has acquired an international dimension, and the idea of a global bank tax has gained momentum.

However, there are still significant differences within Europe, as well as between Europe and the US, on the kind of bank levy that should be applied. The US levy has been received favorably by the Swedish government, which has also introduced a "stability levy". This tax imposes a permanent stability fee at a rate of 0.036% a year on all of a bank's liabilities, excluding equity capital and junior debt securities, which would then be channeled into a special stability fund targeted to reach 2.5% of GDP in 15 years. Instead the majority of European countries including Germany and the UK have announced that they were not considering a similar tax. The British government, as well as the German and French governments, have endorsed the creation of an currency transactions tax (also known as "Tobin Tax") which would charge a small fraction of a per cent on each trade, which has so far received mixed reactions from US authorities. The British and French government have also sought to cover the cost of the crisis by introducing a tax on large bonuses.

Despite these differences, the idea of a tax on banks seems to have found its place on the international agenda and G7 countries officials are at work to coordinate their efforts to reach an international agreement about some forward-looking international levy on banks to help insure against future financial crisis. The idea of a global tax has also gained the support of Mario Draghi, chairman of the Financial Stability Board, as well as important international banks. Gordon Brown has stated that a deal on an international levy on banks could be reached during the next G20 summit in June 2010.

3. The Cap on Size

A second shift in banking regulation introduced by the Obama administration has been the establishment of a limit on size.⁵ In the United States banks were already subject since 1994 to a 10% concentration limit on bank deposits in order to constrain future concentration in the banking sector. However, the usefulness of this cap has progressively been undermined by the decision of the largest US banks to fund themselves through non-deposit liabilities. Indeed, it has been argued that the same constraint on deposits has pushed banks to increasingly fund themselves through short-term and more volatile sources of funding. Moreover the financial crisis has further reinforced the

⁵ Deputy Secretary of the Treasury Neal S. Wolin, Statement before the Senate Committee on Banking, Housing, and Urban Affairs, 2 February 2010. Available at <http://www.ustreas.gov/press/releases/tg530.htm>

concentration in the US financial system as several major banks have rescued and acquired their competitors.

President Obama has thus announced that the existing deposit cap would be supplemented with a broader restriction on the size of the largest financial firms, expanding the existing prohibition on any financial institution holding more than 10% of the deposits insured by the Federal Deposit Insurance Corporation (FDIC) to apply also to other liabilities. The new limit would apply primarily to the major financial firms and constrain their capacity to grow further through acquisitions, although it would not force firms to shrink. At the same time, this cap would not focus on assets and liabilities remaining off balance sheet, despite the crisis has shown that these entities (e.g. special investment vehicles) could also have an impact over the balance sheet of banks.

4. The “Volcker Rule”

Finally, President Obama has announced the introduction of a provision to prohibit investments of a banking firm's capital in trading operations that are unrelated to client business.⁶ In particular, this measure would bar banks from owning, investing in or sponsoring hedge funds and private equity groups, and from engaging in proprietary trading, that is trading conducted solely for the benefit of the bank itself rather than for the benefit of customers or clients. This rule has immediately come to be known as the ‘Volcker rule’, from the name of the former Federal Reserve Chairman who has advocated the move for months.

According to Volcker, the rationale for this rule comes from the expansion of the safety net from the Federal Reserve during the crisis.⁷ During the crisis the Federal Reserve has been forced to extend the discount window previously limited to commercial banks also to investment banks. The Volcker rule seeks to end the implicit extension of taxpayer support also for speculative activities and the moral hazard that the rescue of these institutions has generated.

The Volcker rule has immediately led commentators to draw parallels with the Glass-Steagall Act of 1933, which mandated the division of commercial and investment banks, and was repealed in 1999 by the Gramm-Leach-Bliley Act. However, the new proposal does not seek to scale back banks’ activities to utility-type functions, as it still allows commercial banks to conduct merger and acquisition advisory services, securities underwriting and dealing, and brokerage businesses. Commercial banks would also be allowed to make markets for customers in financial assets and to keep hedge funds that hold clients’ money.

⁶ Deputy Secretary of the Treasury Neal S. Wolin, Statement before the Senate Committee on Banking, Housing, and Urban Affairs, 2 February 2010. Available at <http://www.ustreas.gov/press/releases/tg530.htm>

⁷ PAUL VOLCKER, “HOW TO REFORM OUR FINANCIAL SYSTEM”, NEW YORK TIMES, 30 JANUARY 2010

The Volcker rule has not been immune from criticisms. For instance, the former SEC chairman Arthur Levitt has argued that the ban on proprietary trading would have virtually no impact on the investment or lending activities that caused most bank losses during the crisis. The banking industry has argued instead that it would not be possible to draw a clear line between proprietary trading and market-making on behalf of customers. Bankers have also claimed that regulators should trust the so-called Chinese walls banks have in place between different divisions. Volcker has bluntly dismissed this argument, arguing that the coexistence of proprietary trading and market-making present insolvable conflicts of interests and "bankers know what proprietary trading is and is not. Don't let them tell you any different".

Similarly to the Financial Crisis Responsibility Fee, the impact of the Volcker rule would not be uniform across the banking industry. As the same Volcker has stated, the rule would target a small number of institutions that generate significant revenue from proprietary trading. According to Volcker these would be "maybe four or five" and "perhaps a couple of dozen worldwide". These banks were already scaling back their proprietary-trading activity as a result of the crisis, and revenues generated by proprietary trading have fallen significantly in the last few years. However, the impact of the Volcker rule could be as high 10 percent of revenues in the case of banks such as Goldman Sachs.

Similarly to the bank levy, the Volcker would also apply to the US operations of foreign banking organizations that have a US branch or agency, as well as to the foreign operations of US-based banks. Proprietary trading represents a non-negligible part of the profits of European banks. Analysts have estimated that proprietary trading accounted for 4.9 per cent of revenue at Credit Suisse, 4.3 per cent at Deutsche Bank, 4.2 per cent at Barclays, 3.1 per cent at Société Générale and 1.4 per cent at BNP Paribas. Other analysts have estimated that the plan would cost Credit Suisse, UBS and Deutsche Bank about €4.2bn in revenue next year.

Another concern is that the crisis would simply shift the risk generated by proprietary trading elsewhere, to hedge funds, or to banks in more lightly regulated jurisdictions. This raises the dilemma about whether the Volcker rule could be applied unilaterally by the US or if it requires also the cooperation of other countries in order to be effective. Volcker in his testimony before the Senate Banking Committee on February 2, 2010 argued that these restrictions would only make sense if implemented internationally.

This kind of international consensus has not emerged yet. The French and German government have welcomed the announcement by the Obama administration as a step forward. However, so far they have not manifested the intention to follow the US plan as this would be incompatible with the model of universal banking. In the UK, the chairman of the FSA Adair Turner has argued that separating utility and 'casino' banking "could produce a financial system even more vulnerable to instability than the one we have today".

Also the Financial Stability Board has welcomed the plan but it has stated that this is only one measure in a larger set of options to address the "too big to fail" problem: "targeted capital,

leverage, and liquidity requirements; improved supervisory approaches; simplification of firm structures; strengthened national and cross-border resolution frameworks; and changes to financial infrastructure that reduce contagion risks”.

5. Conclusion

The proposals to introduce a bank levy, a cap on size, and a prohibition on banks from owning, investing in or sponsoring hedge funds and private equity groups and from engaging in proprietary trading represent a significant and sudden shift in the debate over banking regulation reform.

At the same time, they also represent a shift in the balance of power between the actors influencing the US response to the crisis. Until the end of 2009, the agenda-setting over banking regulation has been dominated by the US Treasury and its Secretary Tim Geithner, in a difficult dialogue with Democratic leaders within Congress. The latest proposals raise the profile of the President Obama and its adviser Paul Volcker in charting the US future response to the crisis, while the more Wall Street-friendly Geithner and Larry Summer seem to have been in part sidelined. It is not clear what will be the impact of this twofold shift. The entry of new actors, in particular the direct intervention of Obama, and the introduction of more radical proposals based on limitations on banks activities could add momentum to the regulatory reforms in the US. However, these proposals could also backfire and weaken the reforms currently making their way through Congress. In particular, the risk is that the Volcker rule could give to the Republican Party an opportunity to delay or stall the reforms currently debated within Congress and potentially widen the already significant divisions internal to the Democratic Party on financial regulatory issues.

Besides their impact on the US domestic political system, it will be important to analyze to what extent these latest regulatory proposals will undermine the transatlantic consensus that had emerged between Europe and US. The US approach to the reform of capital requirements and to the regulation of systemically relevant firms have also been endorsed by European countries, as well as at the international level by the Basel Committee and the Financial Stability Forum. It will be important to understand to what extent Europe is willing to follow America’s lead, how determined is the US to act unilaterally in the absence of the European support, and what opportunities for regulatory arbitrage could emerge in the case Europe and the US adopt diverging approaches.