

Through the Looking Glass (Steagall): Banks, Broker Dealers, and the Volcker Rule

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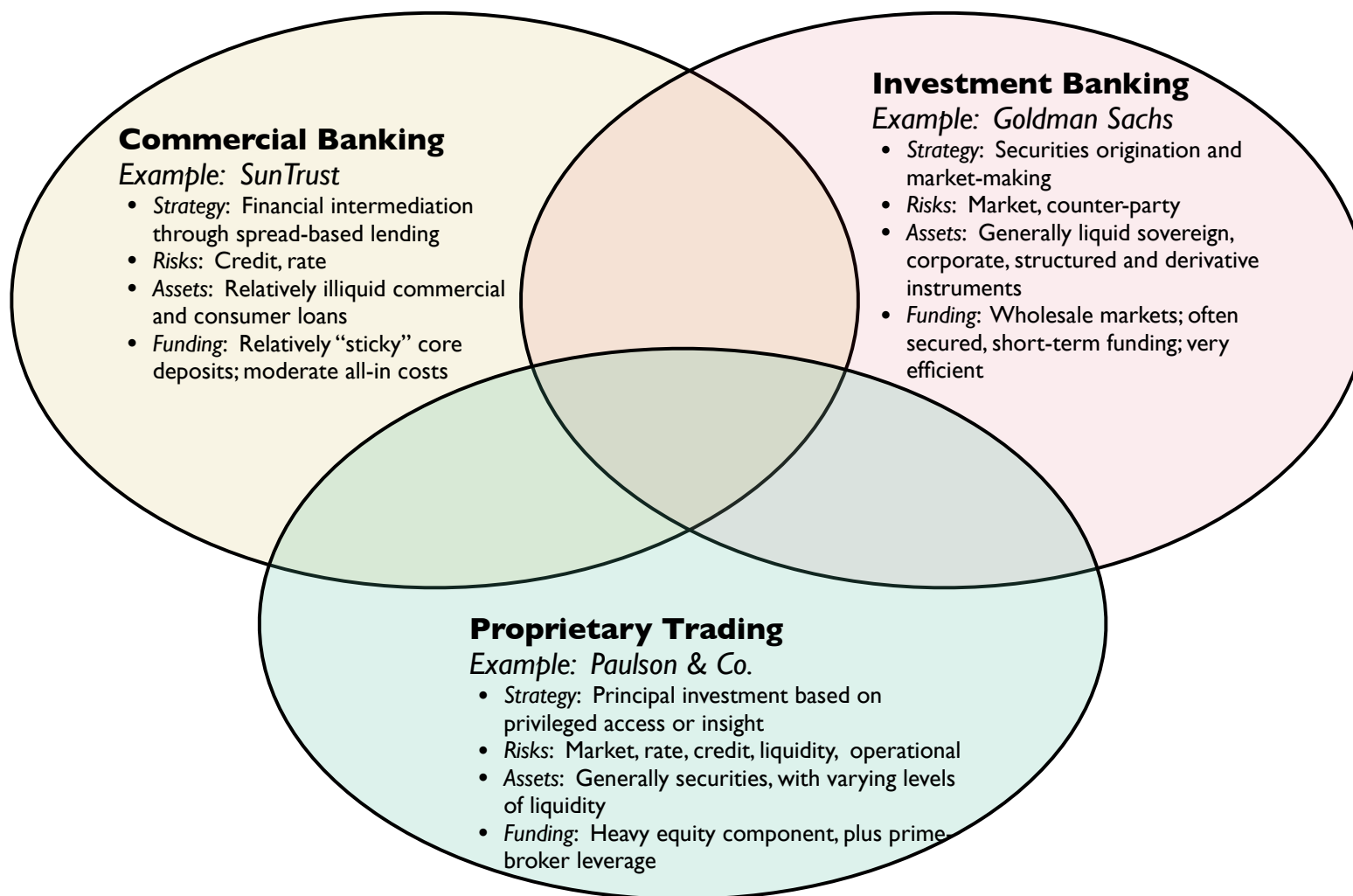
EXECUTIVE SUMMARY

On January 21, the Obama Administration proposed two sets of new measures to contain systemic risk: limits on financial firms' size (as a fraction of market liabilities); and the so-called "Volcker Rule", which would bar bank and financial holding companies from putatively high-risk activities like private equity investing, managing hedge funds, and proprietary trading.

- **A real solution to a non-problem.** Firms that combine elements of the commercial banking, broker-dealer, and proprietary trading business models can pose systemic hazards. But the Volcker Rule focuses on the *least* problematic of those hybridized activities. For sound market-based reasons, commercial banks are simply not involved in significant levels of private equity or hedge fund-like investing.
- **A non-solution to a real problem.** By contrast, broker-dealers (or investment banks) are quite frequently engaged in trading and investing for their own account -- both as a necessary consequence of their market-making function, but also as a means to capture incremental value. Because investment banks (appropriately) fund themselves substantially in short-term and overnight markets, allowing them to take on volatile and illiquid assets is systemically dangerous. Indeed, it was the proliferation of such "shadow banking" that was perhaps the single biggest driver of the credit bubble and ensuing crisis and government response. But the Volcker Rule, as currently defined, does not apply to most investment banks. Indeed, if the largest investment banks (Goldman Sachs and Morgan Stanley) were to give up their bank holding company status, the Volcker Rule would leave even them untouched.
- **Two recommendations.** The Volcker Rule can be improved.
 - First, policy-makers should focus their efforts on preventing too-big-to-fail firms (which are large broker dealers, not banks) from taking on credit and rate risk that their funding structures do not suit; the Volcker Rule should therefore apply to investment banks.
 - Second, rather than trying to define "proprietary trading" (such definitions are hard to create, and easy to get around), policy-makers should adopt a tailored approach to capital requirements. For example, because inventories of securities that are disproportionately large compared to trading flow are more likely to represent proprietary risk, they might carry higher capital requirements.

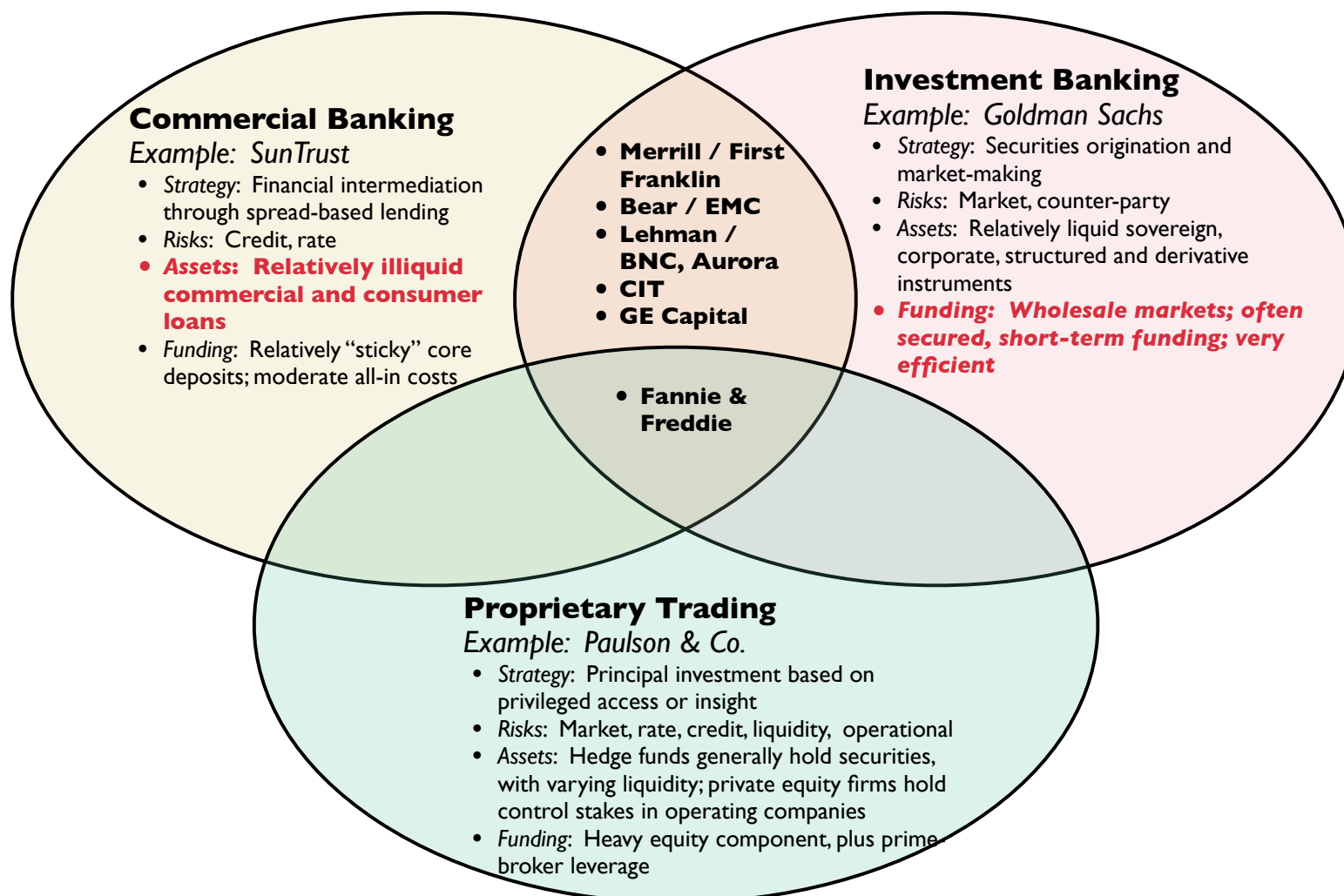
Like the Glass-Steagall regulatory framework, the Volcker Rule focuses on the intersections between commercial banking, investment banking, and proprietary activities. Notably, each of those business models -- in their "pure" forms -- has a funding model that suits its asset risk profile. Commercial banks make relatively illiquid loans, but they have privileged access to relatively resilient core deposit funding. Investment banks hold inventories of relatively liquid securities, which enables them to use extremely efficient, short-term, low-cost funding (like the overnight "repo" markets).

BASIC FINANCIAL BUSINESS MODELS



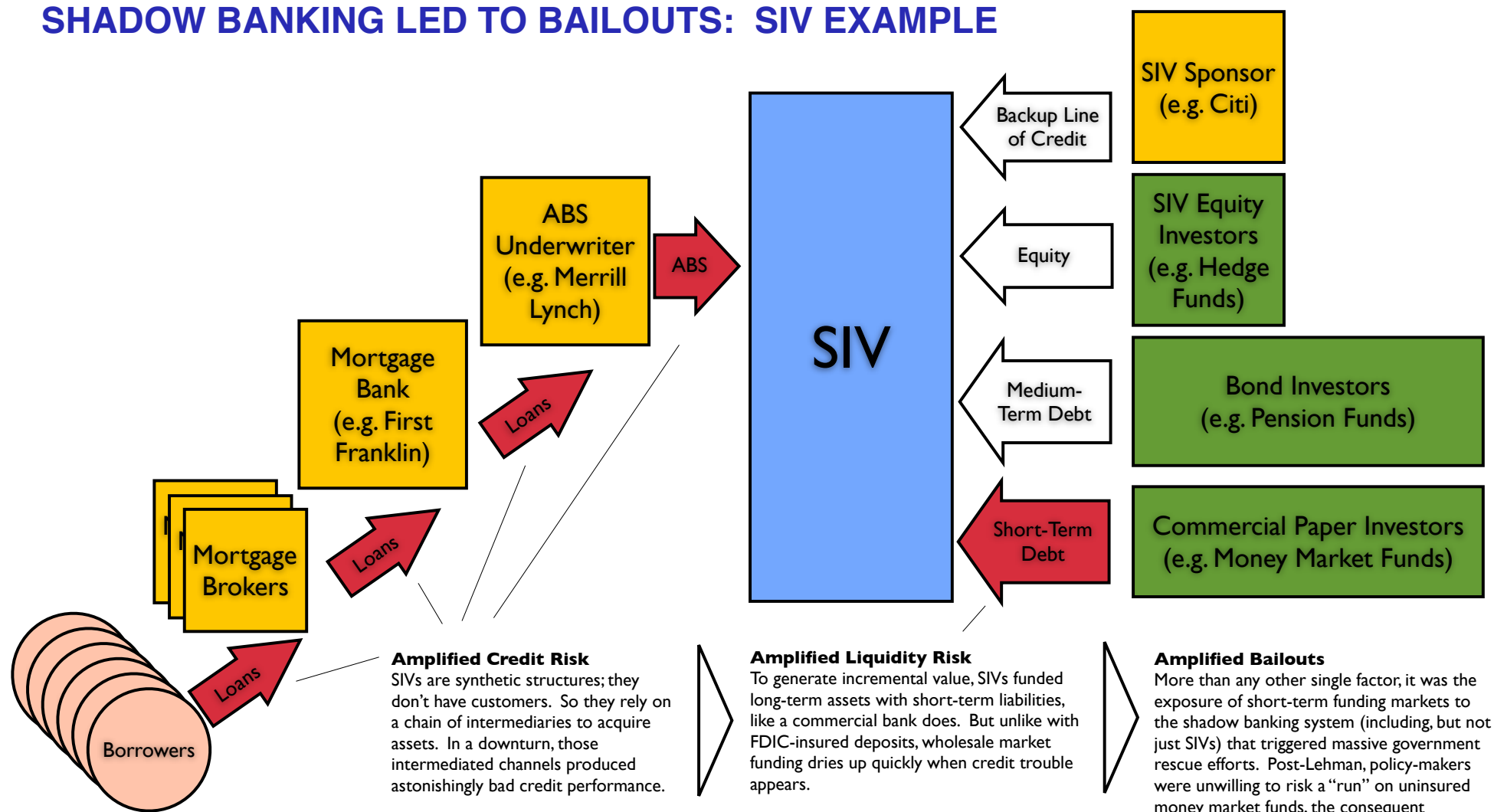
Many of the credit bubble's excesses can be traced to the "shadow banking" sector, which is essentially the intersection between commercial banking and investment banking business models: shadow banks take illiquid credit and interest rate risk (like commercial banks), but fund themselves principally through the wholesale markets (like investment banks). Because of long-recognized regulatory loopholes, shadow banks were also frequently able to operate with significantly lower capital requirements than commercial bank competitors. With both capital and funding advantages in hand, shadow banks grew to some 60% of the U.S. credit system.

DANGEROUS INTERSECTION: THE SHADOW BANKING SECTOR



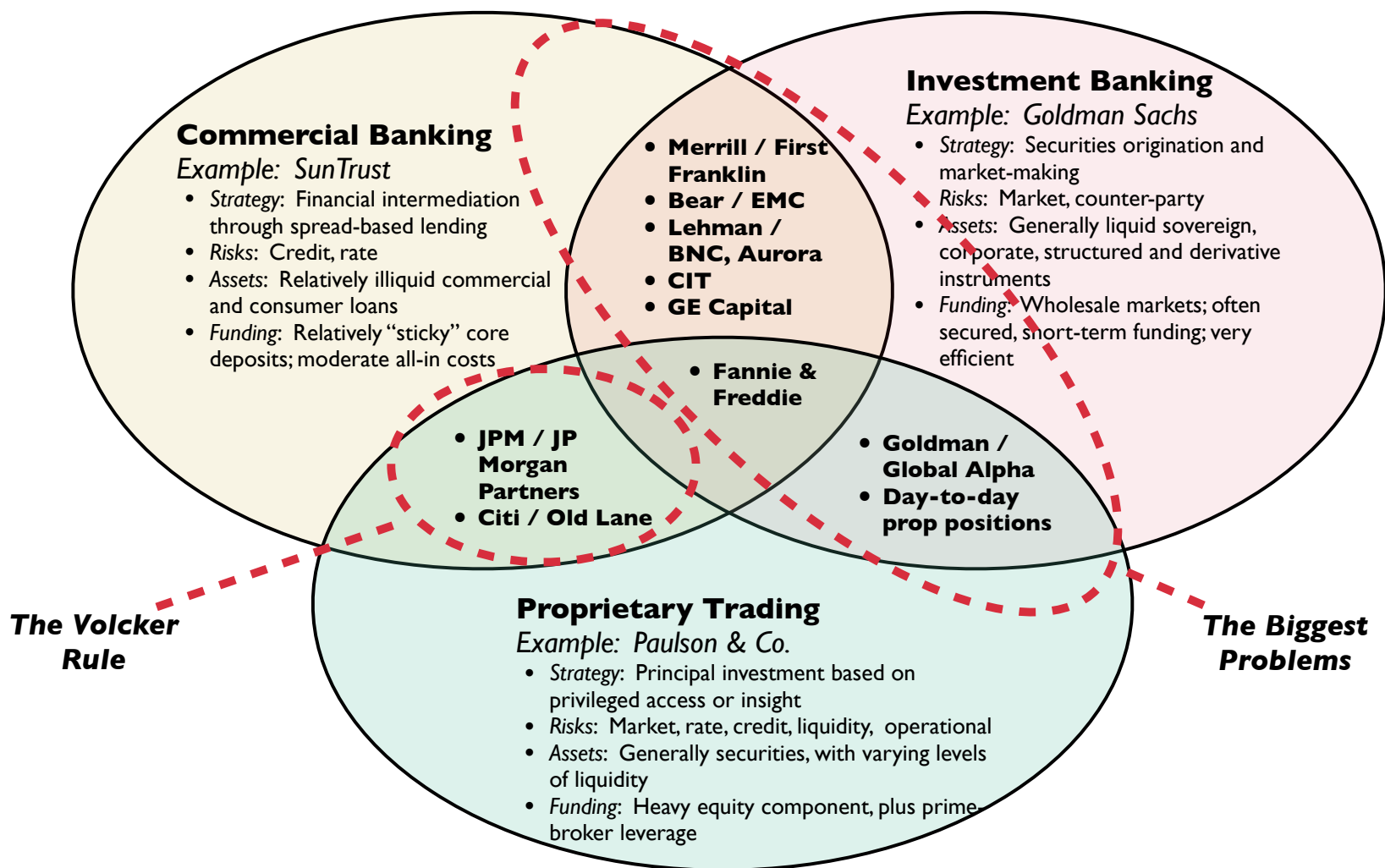
To many investors and policy-makers during the bubble, shadow banking vehicles (like “SIVs”) appeared to perform precisely the same functions as commercial banks, but were more efficient. Unfortunately, shadow banks proved to be extraordinarily fragile; both the asset and liability components of their business models suffered as the credit cycle turned. Unwilling to risk a shutdown in the short-term funding markets, central banks and governments stepped in to prop up the shadow banking system.

SHADOW BANKING LED TO BAILOUTS: SIV EXAMPLE



With that context in mind, the focus of the Volcker Rule, as currently described, seems misplaced -- or at least too narrow. The crisis did not stem from commercial banks stumbling into investment banking businesses; the crisis did stem, in the main, from allowing firms that fund themselves in the wholesale markets to take on credit and rate risk as though they were commercial banks or hedge funds.

FOCUS OF VOLCKER RULE SHOULD SHIFT OR EXPAND



Implementing a re-scoped Volcker Rule will be challenging. But it need not be made more challenging by trying to precisely define “proprietary” activities. A new systemic risk regulator, if it is appropriately staffed and resourced, should be able to accomplish the same objective by appropriately tailoring capital requirements to proprietary risk-taking and market-making activities.

ILLUSTRATIVE NON-LINEAR CAPITAL FRAMEWORK

