A Regulatory Nudge Is Needed

By Martin Hutchinson *Tue, Feb 23, 2010*

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Paul Volcker's proposal that proprietary trading should be spun off from deposit-taking banks is a worthwhile step in the direction of stabilizing the financial services business.

However, when you consider that business in detail, it becomes clear that further breakups are necessary in order to remove the excessive risks from the U.S. economic system.

There are three problems with the current setup on Wall Street: systemic risk, rent seeking and conflicts of interest. The Volcker proposal addresses the systemic risk problem to a great extent, but does not do much about the other two. For a complete solution, we thus need to go further.

Systemic risk

When Treasury Secretary Larry Summers and former Senator Phil Gramm (R-Texas), among others, pushed through repeal of the Glass-Steagall Act in 1999, they didn't give proper thought to the dangers of institutions funding a traders' casino with guaranteed deposits.

The introduction of Glass-Steagall in 1934 had been highly damaging to the economy, because it decapitalized the investment banks, killing off the capital markets for the remainder of the 1930s and playing a major role in prolonging the Great Depression.

 However, by 1999, the investment banks were more than adequately capitalized (provided they followed sound principles of risk management and leverage, which of course they increasingly didn't). Thus, the rationale for allowing commercial banking and investment banking to be combined was shaky at best.

It should have caused further doubt that the trigger for Glass-Steagall repeal was the acquisition of the investment bank Salomon Brothers by Citigroup, itself a quagmire of conflicts of interest that had been bailed out from bankruptcy only eight years before.

However, restoring Glass-Steagall as it was would achieve nothing. After all, the two most serious failures of risk management in the 2008 crash were collateralized debt obligations, involving a mortgage bond market in which commercial banks' securitization operations have always been active, and credit default swaps, a product in which commercial banks were intimately involved from the first.

Conventional underwriting of corporate debt and equity securities, the activity prohibited to commercial banks by Glass-Steagall, was not the problem, as it might have been had the crash occurred with the bursting of the 1999 dot-com bubble. The principal risks involved in finance today are those incurred by traders, but those proliferate in both types of banking.

It’s not clear how Volcker’s ban on proprietary trading in banks benefiting from deposit insurance would work. Every bank foreign exchange desk and money desk trades on the bank’s own account in almost every transaction it makes (relatively few transactions are pure brokerage between two counterparties.)

Thus, however simple the bank’s operations, it cannot avoid “proprietary trading.” Of course you can ban separate “prop trading” desks, but in a naughty world that would drive the proprietary traders to integrate themselves into the operations of the various products concerned, thus negating the effect of the legislation.

The other problem with the Volcker proposal is that even without separate proprietary trading operations, the banks are undertaking risks which they don’t manage properly. Wall Street risk management systems are based on assumptions of Gaussian randomness in markets that are demonstrably far from realistic.

In particular, Wall Street risk management systems understate the risk of several highly risky products such as collateralized debt obligations and credit default swaps. This understatement is in the interest of bank management, which benefits from state bailouts when it all goes wrong. It is even more in the interest of traders, who by and large make the most money from trading the riskiest instruments, and hence welcome artificially large position limits for those instruments.

Since current Wall Street risk management methods are in the interest of those who work on Wall Street, they will not be changed except by regulatory means. Before their alteration they will, even without proprietary trading, leave the Wall Street behemoths in continual danger of explosion.

Rent-seeking

Rent-seeking is another current problem of Wall Street, not addressed by Volcker. This takes many forms, and has resulted from computerization and from the endless proliferation of derivative instruments.

Basically, Wall Street houses, by their substantial market share in trading businesses, acquire insider information about money flows, and then profit by trading on this information. Traders have always done this, of course, and there is no sensible way of making it illegal.

In addition, genuine “crony capitalism” insider information about future finances and future government actions is as available as it always has been, but with larger trading volumes and fewer inhibitions is more usable without technically contravening insider treading legislation.

Thus insider trading, almost all of it technically legal, has acquired an enormously magnified profit potential. This is the principal reason for Wall Street’s greater share of the economy; the genuine value added to third parties from “hedging” or “liquidity” is only a tiny fraction of the rents Wall Street can extract from these markets.

There is no complete solution to this problem, but the best palliative is a “Tobin tax,” a modest ad valorem transaction tax on each trade. By this means, the profitability of “high speed trading” would be eliminated and many of the other insider trading strategies would be reduced in scope and profitability, particularly if the tax were levied on the nominal principal amount of a derivative and not on its theoretical value.

This would in turn swing the power base within Wall Street away from traders and back towards bankers and corporate financiers, whose approach to life is more conducive to maximizing those houses’ genuine economic value added.

Conflicts of interest

The final problem in the Wall Street behemoths, that of conflicts of interest, requires no legislative solution, at least as far as the corporate customers are concerned, but only that the financing business remain adequately competitive.

With behemoths doing corporate financing transactions, any of their customers is faced with huge conflicts in dealing with them. Wall Street pretends to operate internal “Chinese walls” through which sensitive information does not penetrate, but to rely on those is to put yourself entirely under the protection of Wall Street’s ethical integrity, a security currently trading at a very substantial discount.

The solution to these conflicts of interest is “single capacity,” the system under which the City of London acted until the passage of the Financial Services Act of 1986, surely among the most misguided legislation in human history.

Under this system brokers, who sold securities, were kept separate from jobbers, who made markets in them. Both were separate from merchant bankers who arranged financings and carried out mergers and acquisition transactions. When an underwriting took place, the merchant bank arranged the transaction and the brokers sold the underwriting to insurance companies and other large investment institutions, who earned additional income by backstopping deals in this way.

“Proprietary trading” was undertaken by investment trusts, pools of money whose business was to maximize income for their investors, in a similar way to a U.S. hedge fund. As for banking, that was done by the merchant banks if complicated, but the high volume simple transactions were carried out by the clearing banks, home of the nation’s retail deposits but not known for their intellectual heavy lifting.

It worked beautifully, just as well as the modern system, indeed better. It cost far less, in terms of the wealth it extracted from the economy. It was much less risky. And there were few conflicts of interest; each participant in the business, having only one function and capability, was devoted to its own interest rather than torn between the interests of several participants in every transaction.

This system is to some extent returning anyway, with the increasing market share of “boutique” investment banks such as Greenhill & Co. and Evercore Partners, which at least have fewer conflicts of interest than the behemoths. However, a regulatory “nudge” or two would be no bad thing.

As I said, Volcker had a good idea, but he did not go nearly far enough.