

## 'VOLCKER RULE' AND OTHER PROPOSALS FROM OBAMA ADMINISTRATION

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Immediately after the Obama Administration put forward several financial regulation proposals in January 2010, a serious debate on these issues followed. Obama's proposals contain three distinct points:

- Financial Crisis Responsibility Fee, a tax on the difference between the assets and capital of the nation's largest financial organizations, is expected to recoup the TARP cost. The tax aims to make bankers maintain higher capital levels which will improve the soundness of banking institutions;
- A ban on proprietary trading and ownership of hedge funds and private equity firms by banks. This proposal, dubbed 'Volcker rule',<sup>1</sup> will affect all firms holding banking licenses including former investment banks that have just obtained such licenses (Morgan Stanley and Goldman Sachs);
- Restrictions on the liabilities share the largest financial firms can hold.

The first one is rather a populist / fiscal measure and will not have a great impact on the financial sector. It is not clear whether it will prove effective. On the one hand, Americans might not appreciate this method of 'penalizing' bankers (perhaps, a bonus tax would receive a warmer welcome). On the other, 90 billion dollars the levy is expected to raise until 2020 will not cover the TARP losses of 117 billion dollars<sup>2</sup> in a ten-year time. Although the tax will apply to around 50 banks, broker and insurance companies, 60% of the revenue will come from the 10 largest financial firms. The table below contains approximate annual tax amounts<sup>3</sup> to be paid by some banks (calculations are based on the banks' 2008 balance sheets). Obviously, paying this 'penalty' will not be a big problem for the majority of banks: for instance, for Goldman Sachs and Bank of America this tax will amount to just 8% of the bonuses they are handing out (14.4 and 16.2 billion dollars respectively).

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<sup>1</sup> Former Federal Reserve Chairman (1979-1987), Paul Volcker heads the Economic Recovery Advisory Board that initiated these regulatory measures.

<sup>2</sup> Shortly after the US Presidential Administration announced their proposals, the Congressional Budget Office revised the estimated TARP losses lowering them to 99 billion dollars.

<sup>3</sup> Tax=0.15%\* (Assets – Tier 1 Capital – FDIC insured deposits). We assumed that all deposits are federally insured, so the estimation can be considered conservative.

### Estimated FCRF to be paid by the US largest banks (based on the 2008 data, billion dollars)

	Assets	Tier 1 capital	Deposits	Financial Crisis Responsibility Fee
Goldman Sachs	884.6	62.6	27.6	1.2
Bank of America	1817.9	120.8	883.0	1.2
Morgan Stanley	658.8	37.9	36.4	0.9
JPMorgan Chase	2175.1	136.1	1009.3	1.5

Sources: SEC, author's estimates

In our opinion, the Financial Crisis Responsibility Fee is not counter-cyclical and thus unable to prevent accumulation of unwanted negative externalities caused by the financial system operation, in particular, the increase of systemic risk<sup>4</sup>. Rating agencies have already reported the Obama levy-caused worsening of American banks ratings. An idea of mandatory insurance against a financial crisis seems better in this regard<sup>5</sup>: reason prompts that acquiring an insurance policy against an occurrence of a systemic event is more efficient than meeting higher capital requirements.

In reality, however, the 'tax approach' is more likely to be used: many financial market players cannot afford a 'crisis insurance' which will lead to further consolidation and excessive risk taking. Another thing is that insurers' capital will be quickly depleted in case of a systemic crisis and the state will have to bail out them again.

The second measure is much more serious: if the ban on proprietary trading by banks will be applied, both the American and global financial systems will change (some banks will have to close their most profitable branches). Many researchers believe<sup>6</sup> that the virtual reinstatement of the Glass-Steagall Act<sup>7</sup> will bolster the financial sector through restricting risky activities. The banking separation initiative emerged not only because of political leaders' efforts to fight the problem of institutions deemed too big to fail, but also due to the lack of evidence that financial giants' are more efficient than other financial institutions.

<sup>4</sup> Vladimir Kreindel. "Who will measure systemic risk?" [http://www.ifs.ru/upload/systemicrisk\\_31july.pdf](http://www.ifs.ru/upload/systemicrisk_31july.pdf)

<sup>5</sup> Kashyap, A., Rajan, R., Stein, J. (2008) "Rethinking Capital Regulation", Kansas City Symposium on Financial Stability.

<sup>6</sup> Acharya, V., M. Richardson (2010) "Making Sense of Obama's Bank Reform Plans".

[www.voxeu.org/index.php?q=node/4521](http://www.voxeu.org/index.php?q=node/4521)

<sup>7</sup> A US Banking Law (in force from 1933 to 1999) that established Federal Deposit Insurance Corporation and separated commercial and investment banking activities

Other experts believe<sup>8</sup> that Obama's proposals will not push systemic risk out from the US economy because the largest investment banks will give up their banking licenses seeking not to qualify for the limits imposed. In case of a new crisis they will acquire access to the state's discount window for funding by gaining temporary banking licenses. The largest banks' revenues from trading reach 60-70% of their total income. Another problem is in the definition of what constitutes proprietary trading and if this ban should apply to financial companies that focus on mergers and acquisitions and security underwriting. Fortunately, the Obama Administration has chosen not to tighten the hedge fund regulation although many political leaders solicited restrictions.

The third proposal – to limit the amount of deposits a bank can hold – is in line with the antimonopoly tradition and is reminiscent of Alan Greenspan's comparison of the financial sector reform to the division of Standard Oil in 1911.

It is entirely not clear how to define an optimal bank size legislatively and what consequences this measure will lead to. Size limit is a very rough instrument that will rather do harm than good as small banks might lose the competition. Besides, systemic failures are often caused<sup>8</sup> by a financial organization's relations with other market players rather than its size.

At this stage, the Obama Administration's proposals do not seem to be a decisive move towards pushing systemic risks out of the financial sector. Before toughening the legislation, the state should introduce a no-bailout rule for private firms. Repealing FDIC guarantees (guaranteeing deposits is not the state's task) will force private businesses into more thoughtful risk assessment as in case of a crisis taxpayers' money will be unavailable for covering their losses, even in theory. Eugene Fama, a well-known economist, said: "The experiment we never ran is, suppose the government stepped aside and let these institutions fail"<sup>9</sup>.

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<sup>8</sup> Johnson, S. "Will the 'Volcker Rule' Do Anything?" <http://economix.blogs.nytimes.com/2010/01/26/will-the-volckerrule-do-anything/>

<sup>9</sup> An interview with Eugene Fama (<http://www.newyorker.com/online/blogs/johncassidy/2010/01/interview-with-eugene-fama.html>)