As a banker I am constrained to submit this anonomously, and for that I apologize in advance. Although I had written this some time ago, I am submitting this now after President Obama's proposed Volcker Rule because for the first time I believe the core issues are being correctly addressed and have a shot at implementation.

The principles in the Guidance are correct insofar as principles go, and they address precisely the cause of the financial crisis. They are perfectly on target in recognizing the core problem in the financial system, and in 2007-8 I was of the view that something like the guideline was the right approach. (See www.newfinancialsystem.blogspot.com.) However, in the ensuing year the empirical results have shown that although in theory the principles should work, in reality and in practice they do not work.

With the entire financial industry focused on compensation reform, and keenly aware of the social and political anger at actual or perceived excessive compensation what has the industry done? Management and Boards of directors have instructed their staffs and consultants to do whatever has to be done to compensation plans in order to "make them compliant" with the proposed regulatory guidelines, meaning add some features of deferral, references to risk, to capital, etc so as to allow the company to recite such features. However, implicit in such instructions was that such changes were in no way to make any meaningful changes to the end result, i.e., the amount of compensation. The most telling empirical evidence of such behavior was the decision by several banks to act contrary to their own and shareholders interests by raising expensive equity capital solely for the purpose of escaping compensation restrictions by repaying TARP funds. Can there be any clearer evidence of the conflict bankers have in managing other people's money? Consequently, and much to my disappointment, I have become pessimistic whether compensation guidelines administered by management and boards of directors could work, and have come to believe that there are only two true reforms that have a shot at preventing a financial crisis of the kind we are experiencing: either an outright return to Glass Steagall (GS), or a de facto GS, as discussed below.

I am not an economist, but before going further, it would be useful to set forth in layman's terms a couple of basic principles upon which the discussion below is based upon. First, the allocation of savings to those who need credit is a fundamental function necessary for our economy to work. It follows then that decisions on how to allocate those savings in the credit market are important. In our country, we as capitalists prefer, in normal times, to allow such decisions be made by "markets".
Second, there is no such thing as a market, only the collective actions and decisions of individuals; and it is an elementary economic principle that individuals act and make decisions based on their self interest. The credit market would need very little regulation if every individual saver also was the lender of his own money.

But when decisions are made by someone other than the owner of that money, then we do not have pure capitalism, so it is important that such decisions be made as free from personal conflict as possible and as close as possible to what an informed owner would do. This is the primary and most important objective of financial regulation – to establish rules and mechanisms that allow or cause those delegated with the task of allocating capital to do so with the same care and diligence akin to that which the owners of such capital would apply themselves. In other words, to try to approximate how a true "market' system would work. (Actually, this principle applies to all corporations, not just banks. State corporate law tries with very limited success to achieve this by imposing fiduciary duties on directors.)

Lastly, the foregoing discussion does not mention banks per se, rather it speaks to the intermediary function of allocating savings in credit market. The purpose of regulation should not be to regulate banks simply because they have a monopoly on taking deposits, it should be to regulate the intermediary function. There should be no need to find a justification for govt regulation (such as FDIC insurance or govt support), it should be enough that the credit market is crucial to our nations' economy and overall wellbeing. When, through evolution, deregulation, innovation or whatever , it becomes apparent that banks no longer are the only or even main intermediaries in our economy, then the obvious action should be to extend such regulation to all those who participate or are involved in the intermediation process (hedge funds, mutual funds, money market funds, pension funds, insurance companies, mortgage originators, etc), unless they are allocating their own capital, in which case they are not acting as intermediaries.

Now then, as for the Guideline itself, as a general matter, the principles contained therein restate what every company will say has always been the case.

The UN could issue guidelines that all countries should respect each other's interests and should resolve all differences via UN negotiations (actually, they may have already done so, and we all know how effective that's been). These principles sound exceedingly nice and reasonable like motherhood and apple pie, no one can take issue with them. But just as countries will give lip service to principles but act in their self interest in every instance, so too will management and boards of directors act in their self interest. Ask any CEO: their company never knowingly takes on risks that it deems as excessive and their company has active and effective corporate governance, that is until in hindsight the contrary is found. To the extent the principles rely on management or boards of directors to implement they cannot be effective. Furthermore, even if specific rules were adopted they would not be effective if only applied to institutions overseen by the Federal Reserve or any other banking regulator.

Why? Let's examine a couple of things:

1. Curtailing excessive risk taking. The guidelines are intended not to remove incentives for risk taking, but to eliminate incentives for excessive risk taking. What is "excessive"? To those who lived through the depression putting your money anywhere other than under the mattress would be excessive. To a smart 30 year old trader surrounded by older colleagues who own several mansions betting someone else's money that a company's credit will deteriorate seems like a perfectly reasonable risk. Risks can always be rationalized in terms of return. At the height of the bubble in 2005-06 if the question were posed to to Lehman, Bear, Citi Washington Mutual, Countrywide, the Fed, and so on, whether they were taking excessive risks, the answer would have been unanimous – yes they were taking risks but they were well controlled and managed. And there would have been reams of data and risk management reports that would have supported that answer. In banking no one takes excessive risks, we take only reasonable risks and only in hindsight might they seem excessive.

So what would happen if companies were told to devise comp plans in accordance with the guidelines? Take a police precinct where most of the officers receive some money from drug dealers and bookies to leave them alone. If the police commissioner ordered the precinct to come up with a plan to eliminate crime in the neighborhood, what do you think that plan would look like? It will look and say all the right things but it will not eliminate the source of the income. Or take the government agencies who were charged with coming up with a reform plan that streamlined the regulatory process. Was it any surprise that every agency testified that its existence was necessary? So what makes anyone think that the men (and to lesser extent) women who make it to a position of power on Wall Street or in banking anywhere are going to voluntarily curtail their income.

The principles, although well intended, are sufficiently broad and general (which was the intent) as to permit banks to create plans that are customized to take into account differences in each bank's business. That sounds reasonable, but it is not effective. If every team in baseball were to adopt their own rules, they would do so depending on its strengths, whether it be power hitting, speed, pitching defense. Plans will be developed that on their face appear consistent with the principles but which will not reduce the total amount of compensation. And that is the point: the amount of total compensation.

Should US regulators try to enact specific numerical guidelines, say as percentage of assets, capital, profits, etc? Other countries seem to be leaning that way. That could work, but it is a task that could not be completed by regulators as there are too many different entities, too many different situations, and smells too much like centralized controls that are anathema to US capitalism.

Some may think it may be possible to affect the amount of compensation by increasing capital requirements and leverage ratios, and as discussed n 4 below, that too may work, but that can have unintended consequences -- it can lead banks to take greater risks to get greater returns. Moreover, and more significantly, since as a rule, the amount of compensation is directly correlated to size, more so than profitability, there will be even greater incentive for institutions to become bigger.

2. Strong corporate governance and effective oversight by Board. If curtailing excessive risks taking sounds like apple pie, then this is the vanilla ice cream topping. Legislators and regulators should just stop using terms and ideas like corporate governance, boards of directors, splitting CEO/Chairman titles, independent compensation committees, etc when discussing reforms intended to prevent a similar financial crisis.

They sound nice, they can't hurt and are hard to argue against. But they would absolutely have no effect. Boards meet too infrequently, are often not sufficiently informed or sophisticated about details of business, in many cases they are selected by CEO and are themselves often in similar positions at their companies. Outside Directors are of three types – retired senior execs, current senior execs and academics. For all three types it is a part time job, and there is no way they can be expected to comprehend much less monitor and control what goes on in a major bank by spending few hours a month reading materials prepared by the very same management they are supposed to oversee. These are people who want to be on the boards, not because they have an altruistic desire to help shareholders who they do not know, rather they are there for some personal benefit – monetary or reputational – and the tendency is to go along with management. In practice, ask anyone who has served on a board, with few exceptions, it is illusory to believe that directors hold the key to protecting an institution and its shareholders. The best they can do is to hire a capable CEO and senior management, and then hope they do the job. The Board cannot be reliably counted on to oversee and manage the conflicts without regulatory review and regulators and academics should start being realistic about this.

3. Return to Glass Steagall (GS). Can anything be done? We can try, as discussed in 4 below, and we may be able to come close to success, but short of going back to Glass Steagall and eliminating the possibility altogether of banks engaging in proprietary trading and other higher risk businesses, there is no sure way of controlling the inherent conflict in receiving compensation based on the allocation or use of other peoples money which led to the financial crisis.

At a luncheon speech in NY at the Economics Club Chairman Bernanke expressed his view that it was not proprietary trading, but lending that got banks in trouble. I think the Chairman, for whom I have profound respect as a leading thinker in this area, may not fully understand how institutions actually work and how senior management makes decisions, and as result he misses the point on this particular issue.

Yes, GLB and prop trading may not have on their face been direct causes of the crisis, but they were key culprits, the sine qua non in allowing the crisis to occur by freeing bankers from restraints that Glass Steagall put in place to control self interest and conflicts. To understand this one needs to understand how the securities business and the inherent conflicts embedded therein work.

The huge expansion of securitizations was directly a result of allowing banks to underwrite and deal in ABS as a result of GLB. There were huge fees generated in underwriting and selling ABS. In order to successfully have an underwriting business, you need a distribution channel, and in order to have a distribution channel you need to provide not only research support, but liquidity – as every underwriter knows, if you sell it you better be ready to buy it back at market price.

Once GLB gave banks the ability to offer liquidity by making markets, the underwriting door swung wide open and all parts of the machine, sales, trading and origination went into high gear. Sales staff demanded more product and banks obliged – not just by loosening mortgage underwriting criteria, but creating new standards, such as covenant lite in leveraged finance and loosening other corporate underwriting criteria. It even got to the point that banks set up their own SPCs to buy the securities they underwrote themselves. It was extremely convenient to make loans or extend credit (direct and indirect) to the SPCs who supported the underwriting and dealing business. In addition, the creation and expansion of bank trading desks that was needed to create such secondary market liquidity also led to the expansion in size and number of the "customers" or counterparties, the thousands of funds and money managers that bought the instrument from the underwriters in the first place, and as the number of counterparties grew they in turn also led to further expansion of banks' trading desks, and so on. Banks used their balance sheet to provide liquidity to the market, both by buying instruments and by providing credit lines to such counterparties. The decisions to extend such credit and to "manage" or justify such increased risks were clearly influenced and conflicted by the rewards generated in the underwriting and dealing sectors of the bank holding companies.

This is what happened in the 1920s when banks used loans and other credit to enhance their underwriting and dealing. Recognizing this conflict, Congress banned banks from underwriting and dealing – not because underwriting and dealing were inherently more risky than commercial lending, but because putting them all together under one roof creates conflicts and opportunities too good for any smart banker to pass up. Basically if you can make more money underwriting and dealing, it is hard not to use depositors' money to support and grow that business.

Depositors give their money to receive 1%, and they give it to banks to use without restriction. Unless there are some regulatory restrictions on how banks can use that money, bankers will naturally gravitate to the highest possible return consistent with their risk profile. At all times while Lehman, Bear, Citi,AIG were building up their portfolios and generating huge profits their CEOs, the CROs and other officers knew they were taking significant risks, but to a person if they were asked they would have said that they did not think they were taking excessive risks. So this bring us back to the point of beginning – without placing some limits on the ability of bankers to use OPM, there will be no limits.

4. De Facto Glass Steagall. Not perfect, and susceptible to unintended consequences, but if: a) capital is strictly defined as common equity, b) minimum capital requirements are increased to 8-10%, c) all risks are captured (not just GAAP), including those of nonbank affiliates, and d) items a-c are applied to all entities involved in the intermediary process (defined generally as any entity that takes capital from others and allocates capital as credit to ultimate borrowers who produce goods and services, or who participates in such allocation process such as in secondary trading, asset or pension management, derivatives dealer/investor) and d) all incentive comp plans must have a charge for core capital, that is risk adjusted cost of capital built in (also consider incentives for rejecting transactions; currently, there are only incentives for approving transactions, even if it turns out in the future to be a bad deal, bad transactions are worth taking the risk. Prudent rejection should be rewarded just as risk taking is); you may be able to force such entitles to engage in activities that mirror what GS required.

It is critically important as discussed in item 5 below, that item (c) be part of the solution. The significant impact and influence of the shadow banking system on the regulated banking system is unfortunately not given enough recognition. Focusing only on systemically significant institutions misses the point – even though some nonbanks may be insignificant from the perspective of disrupting the financial system, in reality such entities lead the way in determining the pricing, products, compensation, recruitment and behavior that their systemically significant cousins follow. The financial landscape at the time GS was adopted was such that there were no nonbanks, and therefore no need to devise rules to include them – the only rule needed at the time to regulate the allocation of savings to the credit markets was to regulate entities that took deposits and define them as banks. The world has obviously changed to the point that prior to the financial crisis non deposit taking entitles were in some markets, such as leveraged finance, providing more than 70% of the credit. Any attempt to restore GS without recognizing and addressing this change will not succeed.

The foregoing would exempt any entity using their own capital, namely any partnership, like the investment banks of old. Those who rely on their own capital need not be supervised by govt – their own self interest is perfectly aligned, and that should be the goal of any incentive comp plan – to put the person receiving compensation in the same economic satiation as if he were investing his own money. Will this impair risk taking or entrepreneurship? In banking, yes it might, but that's the way it's supposed to be – there are plenty of entrepreneurs and venture capital players that play the role of risk taking – banks are supposed to act as the restraint, not every entity can be a venture capitalist. Also, privately held investment banks that risk their own capital (note that the securities laws make it clear that even if an underwriter sells off its entire position, it retains liability for negligent underwriting) will supply the right dose of risk taking for the economy.

This will have a couple of effects: Many institutions will become less profitable, banking will become more of a utility than gambling business. Entities will be forced to generate profits not from leverage but from production. Less credit will be available, less people employed in the financial services business. With less profits, compensation should decrease; and since all entitles are subject to same rules, bankers will not be able to arbitrage one entity against another. Will financial innovation be hurt? Doubtful, only so many (legitimate) ways you can extend credit. Will the best and brightest scientists and engineers from schools like MIT and others decide to forgo careers in finance? Maybe, but perhaps that's the way it should be in the first place.

5. Application of guidance/rules to all entities. The credit market is as vital to our nation's market economy as our defense system is to our security. Any entity that wants to participate in the system should be subject to the same rules. And how should the system defined? Not by reference to govt support or FDIC insurance. Not by some out of date reference to deposit taking ability. The system is simple: any entity that is involved in the intermediation process, that is, the process of taking money from that part of our society that are savers and allocating it to parts of our society that can use that money to produce goods and services. This would include all primary players –banks, insurance companies, money market funds, pension funds, etc and also all secondary market players – derivatives traders, market makers, hedge funds, traders – all those who gamble and speculate on the underlying credits. The only exception should be those who participate in the process, but do so with their own capital – if Bill Gates wants to use his money play, he should be free to do so without any restriction. This was the case in 1933 when Congress enacted GS, when banks constituted the entire credit system. Virtually all mortgages and loans were made by banks, and they were all subject to the same rules.

The major fault with Volcker's Rule lies with this issue. The problem is the continuing focus on the concept of "banking" as tied to "deposit taking" and the purpose of govt regulation being to protect deposits., and the justification for regulation being govt guarantees. Yes, protecting deposits is key, but as stated above the real purpose should be to protect the credit markets as ultimately that is the only true long term way to protect deposits. And protecting the credit markets requires subjecting all those who participate in it using other peoples money (not just "deposits") to a set of basic rules intended to mitigate the inherent conflict and to allow constructive, but not destructive competition.

To illustrate why this is so important to protecting deposits consider the following two business models, the regulated bank and the unregulated lender or nonbank.
The bank raises deposits at a certain interest rate, and the nonbank raises funds, sometimes from the same sources (such as when bank customers move money from banks to money market funds) at competitive rates. Unlike the nonbank, the bank however, has a competitive disadvantage in that it has to maintain a certain high cost infrastructure (e.g., compliance , risk management, internal audit, policy and procedural staffs, etc) to satisfy supervisors and regulators. Although banks and nonbanks have uneven cost structures, both banks and nonbanks compete in the same market for same customers. This cost imbalance allows nonbanks to offer better rates to raise funds and also better rates to make loans. This arbitrage opportunity does not go unnoticed – there were plenty of investment bankers, packagers, etc who facilitated, for significant fees, the nonbanks' efforts to raise funds by packaging, securitizing and recycling the loans originated by nonbanks. In response, banks will find ways to compete, on the fundraising side, the lending side and on the human resource recruitment side. In many ways, the banks have to find ways to be like nonbanks if they are to prosper and continue to satisfy both shareholders and depositors.

This is frequently overlooked – the fact that irrespective whether the non banks may have the size or significance to imperil the financial system (actually in the case of AIG, GS and MS they did), they nonetheless have a critical role in influencing the behavior of the banks.
The solution has to be to create one single set of basic rules –uniform standards if you will, for capital, for underwriting, for risk management, for compliance, etc for everyone who participates in the game. The universe of regulated entities will be significantly larger, but that could easily be managed if instead of having two or three regulators for

banks now, all state and federal bank regulators were combined to regulate all such entities – there need be no increase or decrease in number of actual examiners and supervisors, there are plenty of them already, just allocate them to cover other entities, no regulator would lose their job.

While on the subject of reform generally, a couple of other points:

6. Licensing of Bankers
Decisions on how to allocate capital in the credit market are arguably the cornerstone of capitalism. When made by someone other than the owner of that capital, it is important that such decisions are made as free from personal conflict as possible and as close as possible to what an informed owner would do. Why would those decisions be entrusted to people with vastly different and in many cases inadequate levels of understanding of what they are doing?

Anyone dispensing medical, legal, engineering, architectural, nursing, even securities and financial advice require a minimum level of training and licensing. How is it that those charged with actually deciding how to allocate the economy's debt capital, which has a macro impact far greater than any other profession, are left to do so based solely on … however they deem appropriate (which, in the absence of any other guidance, will be in accordance with existing incentives).

Anyone allocating credit should have a minimum understanding of credit, cash flow analysis, and most of all history. It is quite amazing that so many credit market participants, coming from various backgrounds, although perhaps highly educated, have no knowledge at all about past financial history and events.

As with all licensing schemes, this is not an answer for all problems and does not ensure competency, but it should help the overall process.

6. Global coordination. There does not need to be one global regulator, but there is a need for regulators in major financial centers to coordinate and agree on basic principles in respect of the credit market. More specifically, coordination means that jurisdictions should not use relaxation of rules to compete with each other to attract credit market participants. This will require political discipline in London, NY, Zurich, Tokyo, Hong Kong, and other financial centers where jobs and taxes will be at stake. Just as regulation in the US should cover banks and nonbanks in the financial arena, imposition of a core set of uniform rules for participants wherever they do business will avoid the downward spiral of regulation similar to what happened in the US when regulated entities chased profits of their unregulated brethren, and what made London the jurisdiction of choice for many banks, including US banks, to centralize their derivative operations.