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Proposal: 1432 (RIN 7100 AD 82) Reg. V V - Proprietary Trading and Certain Interests In, and Relationships

Subject: Volcker Rule -- Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and R

Comments:

Why the Volcker Rule is a Bad Idea

January 25, 2010

Old, historic towns such as Washington are not new to ghosts. The intensity of debates past persists in the air over generations. Glass-Steagall is one such debate. The accession of FDR to the presidency before it is another. Washington had gone one full cycle since the Great Depression with Gramm-Leach-Bliley (GLB), from before FDR back to before FDR, and back again with the Volcker Rule, seeking some middle ground somewhere between Hoover and FDR, as if this is where Obama wants to be politically as president.

The announced intent to separate hedge funds and private equity from the rest of bank holding company activities creates interesting possibilities, politically: there is a wing among the Democrats who want to reinstate Glass-Steagall, not in spirit but the way it was. To them, Paul Volcker was too soft. He had only restricted leveraged borrowing. There is another group, to the right, consisting mostly of bankers, conservatives and Republicans which thinks that cutting off access to leveraged borrowing is too draconian. It is undue interference in how the market place ought to work. The administration, which is trying to position itself between Hoover and FDR, will be pulled on either side by both of these groups.

Within the administration there are economic warriors from administrations past who would ideally not want the government to have anything to do with hedge funds and private equity when reforming financial regulations but have reluctantly gone along with the Volcker Rule because of the stature of Paul Volcker.

Volcker, in many ways, satisfies the status quo. His rule changes the rules of the game so as not to really change them. Volcker would have been better off working on consumer protection because his rule really does not change the financial markets but focuses on protecting the consumers from the risky behaviors of the financial markets. Only the insured deposits will be safeguarded by the Volcker Rule. The rest of the systemic risks persist. Therefore, the White House's effort to reform financial markets regulations is incomplete.

If those on the left in the Democratic Party exert greater pull, the Congress could end up reinstating Glass-Steagall, annulling GLB (or Citigroup). Still, separating all other financial market activities from commercial banking will not undo financial innovation. This innovation, besides stocks and bonds to raise capital, was non-existent in the Depression Era. That commercial banks cannot in anyway relate themselves to other financial functions, does not also mean that other financial functions cannot relate to commercial banks. The Volcker Rule is not bi-directional. Investment banks, hedge funds and private equity can continue to acquire the assets of commercial banks, replenishing their balance sheets with cash to keep on lending. The acquired commercial bank assets will be turned into securities and other derivatives just as in the past. That these activities are performed by separate entities will not in any way mitigate systemic risks, besides buffering potential bank runs. And it is foolhardy to outlaw financial innovation. Therefore, why separate?

The group on the right which is resisting the Volcker Rule, therefore, has a distinct advantage. Leveraged borrowing should indeed be better regulated, but zero leverage is as draconian as the administration's arbitrary limits on what is indeed excessive executive compensation. There are better ways to regulate both.

If consumer borrowing is being regulated based on loan risk, so can borrowing by financial institutions. The money markets must determine the risk premia (or lending rates) based on the levels of risk being taken. This crisis was caused by skewed risk premia: the underlying risk did not correspond to the rates of borrowing to engage in that risk, whether the risk takers were home owners or investment bankers. The yields on risky securities were lower than they should have been.

All financial markets functions must be brought under regulation that is suitable to the type of activity and the regulatory institutions of the government must be streamlined to enable effective enforcement. This means, for the Fed to regain the credibility that Volcker had rendered it, it must lose its ability to regulate the financial markets to introduce, not moral hazard, but checks and balances to minimize conflicts of interest within government.

Rules, to be credible, must mean something.
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