Even Better Volcker Rules

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By Simon Johnson
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This morning the Senate Banking Committee again takes up the issue of the "Volcker rule." As put forward by President Obama on Jan. 21, the plan would limit the future growth of our largest banks and prevent big banks from engaging in so-called "proprietary trading" on their own account.

Today's hearing is actually the second of a pair; on Tuesday, Paul Volcker and Deputy Treasury Secretary Neal Wolin testified as proponents of the new plan. The reception was mixed and generally not positive. Both Republicans and Democrats seem to object to the administration's introducing what they see (correctly) as a substantially new proposal at this point in negotiations over a potential Senate financial reform bill.

Thursday's panel could be even more heated. The financial industry is represented by heavyweights, including Gerry Corrigan of Goldman Sachs and John Reed, former chief executive of Citibank. The panel also includes Hal Scott of Harvard Law School; Barry Zubrow, chief risk officer of JPMorgan Chase; and me.

I plan to say that while the general principles behind the Volcker rule make sense and there is no case for keeping our largest banks anywhere near their current size, the specific proposals outlined so far by the administration are less persuasive.

Capping the size of our largest banks at their current level today is a strange idea. It is highly unlikely that, after 30 years of excessive financial deregulation, the worst crisis since the Great Depression, and an extremely generous bailout, we find ourselves with the "right" size for big banks.

Furthermore, limiting the size of individual banks relative to total nominal liabilities of the financial system cannot be appealing, as this would not be "bubble proof." For example, if housing prices were to increase tenfold, the nominal assets and liabilities of the financial system would presumably also increase markedly relative to gross domestic product. When the bubble bursts, it is the size of individual banks relative to G.D.P. that is the more robust indicator of the damage caused by a bank failure — hence the degree to which it would be regarded as too big to fail.

Also, splitting proprietary trading from integrated investment-commercial banks would do little to reduce their overall size.

The too-big-to-fail banks would find ways to take similar-sized risks, in the sense that their upside during a boom would still be big and the downside in a bust would have dramatic negative effects on the economy — and force the government into some sort of rescue to prevent further damage.

The most straightforward and appealing application of the principles behind the Volcker rule is: Do not allow financial institutions to be too big to fail; put a size cap on existing large banks relative to G.D.P., forcing these entities to find sensible ways to break themselves up over a period of three years.

CIT Group was not too big to fail in summer 2009; it then had around $80 billion in total assets. Goldman Sachs was too big to fail in fall 2008, with assets over $1 trillion. If Goldman Sachs were to break itself up into 10 or more independent companies, this would substantially increase the likelihood that one or more could fail without damaging the financial system. It would also greatly improve the incentives of Goldman management, from a social perspective, encouraging them to be much more careful.

Addressing bank size is not a panacea. In addition, capital requirements need to be strengthened dramatically, back to the 20 to 25 percent level that was common before 1913 (i.e., before the creation of the Federal Reserve, when the government effectively had no ability to bail out major banks). Capital needs to be risk-weighted, but in a broad manner that is not amenable to gaming (i.e., quite different from Basel II and related approaches).

Such strengthening and simplifying of capital requirements would go substantially beyond what the Obama administration has proposed and what regulators around the world currently have in mind. In November 2009, Morgan Stanley analysts predicted that new regulations would result in Tier 1 capital ratios of 7 to 11 percent for large banks — i.e., below the amount of capital that Lehman had immediately before it failed.

The capital requirements for derivative positions also need to be simplified and strengthened substantially. For this purpose derivative holdings need to be converted according to the "maximum loss" principle, i.e., banks should calculate their total exposure as they would for a plain-vanilla non-derivative position; they should then hold the same amount of capital as they would for this non-derivative equivalent. For example, if a bank sells protection on a bond as a derivative transaction, the maximum loss is the face value of the bond so insured. The capital requirement should be the same as when the bank simply holds that bond.

Paul Volcker has single-handedly opened the door to serious financial reform. We should make sure that, as his proposals are discussed, they become clearer, stronger and more likely to rein in overly powerful and dangerously big banks.

Simon Johnson is professor at M.I.T.'s Sloan School of Management and a senior fellow at the Peterson Institute for International Economics.