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BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE
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Mr. Chairman, Members of the Banking Committee:

You have an important responsibility in considering and acting upon a range of issues relevant to needed reform of the financial system. That system, as you well know, broke down under pressure, posing unacceptable risks for an economy already in recession. I appreciate the opportunity today to discuss with you one key element in the reform effort that President Obama set out so forcibly a few days ago.

That proposal, if enacted, would restrict commercial banking organizations from certain proprietary and more speculative activities. In itself, that would be a significant measure to reduce risk. However, the first point I want to emphasize is that the proposed restrictions should be understood as a part of the broader effort for structural reform. It is particularly designed to help deal with the problem of “too big to fail” and the related moral hazard that looms so large as an aftermath of the emergency rescues of financial institutions, bank and non-bank, in the midst of crises.

I have attached to this statement a short essay of mine outlining that larger perspective.

The basic point is that there has been, and remains, a strong public interest in providing a “safety net” –in particular, deposit insurance and the provision of liquidity in emergencies – for commercial banks carrying out essential services. There is not, however, a similar rationale for public funds - taxpayer funds - protecting and supporting essentially proprietary and speculative activities. Hedge funds, private equity funds, and trading activities unrelated to customer needs and continuing banking relationships should stand on their own, without the subsidies implied by public support for depository institutions.

Those quintessential capital market activities have become part of the natural realm of investment banks. A number of the most prominent of those firms, each heavily engaged in trading and other proprietary activity, failed or were forced into publicly-assisted mergers under the pressure of the crisis. It also became necessary to provide public support via the Federal Reserve, The Federal Deposit Insurance Corporation, or the Treasury to the largest remaining American investment banks, both of which assumed the cloak of a banking license to facilitate the assistance. The world’s largest insurance company, caught up in a huge portfolio of credit default swaps quite apart from its basic business, was rescued only by the injection of many tens of billions of dollars of public loans and equity capital. Not so incidentally, the huge financial affiliate of one of our largest industrial companies was also extended the privilege of a banking license and granted large assistance contrary to long-standing public policy against combinations of banking and commerce.

What we plainly need are authority and methods to minimize the occurrence of those failures that threaten the basic fabric of financial markets. The first line of defense, along the lines of Administration proposals and the provisions in the Bill passed by the House last year, must be authority to regulate certain characteristics of systemically important non-bank financial institutions. The essential need is to guard against excessive leverage and to insist upon adequate capital and liquidity.

It is critically important that those institutions, its managers and its creditors, do not assume a public rescue will be forthcoming in time of pressure. To make that credible, there is a clear need for a new “resolution authority”, an approach recommended by the Administration last year and included in the House bill. The concept is widely supported internationally. The idea is that, with procedural safeguards, a designated agency be provided authority to intervene and take control of a major financial institution on the brink of failure. The mandate is to arrange an orderly liquidation or merger. In other words, euthanasia not a rescue.

Apart from the very limited number of such "systemically significant" non-bank institutions, there are literally thousands of hedge funds, private equity funds, and other private financial institutions actively competing in the capital markets. They are typically financed with substantial equity provided by their partners or by other sophisticated investors. They are, and should be, free to trade, to innovate, to invest – and to fail. Managements, stockholders or partners would be at risk, able to profit handsomely or to fail entirely, as appropriate in a competitive free enterprise system.

Now, I want to deal as specifically as I can with questions that have arisen about the President's recent proposal.

First, surely a strong international consensus on the proposed approach would be appropriate, particularly across those few nations hosting large multi-national banks and active financial markets. The needed consensus remains to be tested. However, judging from what we know and read about the attitude of a number of responsible officials and commentators, I believe there are substantial grounds to anticipate success as the approach is fully understood.

Second, the functional definition of hedge funds and private equity funds that commercial banks would be forbidden to own or sponsor is not difficult. As with any new regulatory approach, authority provided to the appropriate supervisory agency should be carefully specified. It also needs to be broad enough to encompass efforts sure to come to circumvent the intent of the law. We do not need or want a new breed of bank-based funds that in all but name would function as hedge or equity funds.

Similarly, every banker I speak with knows very well what "proprietary trading" means and implies. My understanding is that only a handful of large commercial banks – maybe four or five in the United States and perhaps a couple of dozen worldwide – are now engaged in this activity in volume. In the past, they have sometimes explicitly labeled a trading affiliate or division as "proprietary", with the connotation that the activity is, or should be, insulated from customer relations.

Most of those institutions and many others are engaged in meeting customer needs to buy or sell securities: stocks or bonds, derivatives, various commodities or other investments. Those activities may involve taking temporary positions. In the process, there will be temptations to speculate by aggressive, highly remunerated traders.

Given strong legislative direction, bank supervisors should be able to appraise the nature of those trading activities and contain excesses. An analysis of volume relative to customer relationships and of the relative volatility of gains and losses would go a long way toward informing such judgments. For instance, patterns of exceptionally large gains and losses over a period of time in the "trading book" should raise an examiner's eyebrows. Persisting over time, the result should be not just raised eyebrows but substantially raised capital requirements.

Third, I want to note the strong conflicts of interest inherent in the participation of commercial banking organizations in proprietary or private investment activity. That is especially evident for banks conducting substantial investment management activities, in which they are acting explicitly or implicitly in a fiduciary capacity. When the bank itself is a "customer", i.e., it is trading for its own account, it will almost inevitably find itself, consciously or inadvertently, acting at cross purposes to the interests of an unrelated commercial customer of a bank. "Inside" hedge funds and equity funds with outside partners may generate generous fees for the bank without the test of market pricing, and those same "inside" funds may be favored over outside competition in placing funds for clients. More generally, proprietary trading activity should not be able to profit from knowledge of customer trades.

I am not so naive as to think that all potential conflicts can or should be expunged from banking or other businesses. But neither am I so naïve as to think that, even with the best efforts of boards and management, so-called Chinese Walls can remain impermeable against the pressures to seek maximum profit and personal remuneration.

In concluding, it may be useful to remind you of the wide range of potentially profitable services that are within the province of commercial banks.

- First of all, basic payments services, local, national and worldwide, ranging from the now ubiquitous automatic teller machines to highly sophisticated cash balance management;

- Safe and liquid depository facilities, including especially deposits contractually payable on demand;
- Credit for individuals, governments and businesses, large and small, including credit guarantees and originating and securitizing mortgages or other credits under appropriate conditions;
- Analogous to commercial lending, underwriting of corporate and government securities, with related market making;
- Brokerage accounts for individuals and businesses, including "prime brokerage" for independent hedge and equity funds;
- Investment management and investment advisory services, including "Funds of Funds" providing customers with access to independent hedge or equity funds;
- Trust and estate planning and administration;
- Custody and safekeeping arrangements for securities and valuables.

Quite a list. More than enough, I submit to you, to provide the base for strong, competitive – and profitable - commercial banking organizations, able to stand on their own feet domestically and internationally in fair times and foul.

What we can do, what we should do, is recognize that curbing the proprietary interests of commercial banks is in the interest of fair and open competition as well as protecting the provision of essential financial services. Recurrent pressures, volatility and uncertainties are inherent in our market-oriented, profit-seeking financial system. By appropriately defining the business of commercial banks, and by providing for the complementary resolution authority to deal with an impending failure of very large capital market institutions, we can go a long way toward promoting the combination of competition, innovation, and underlying stability that we seek.