Industry Spotlight

FINANCIAL REFORM

In recent weeks, the Group of Thirty, representing eminent economists and policymakers in the United States and abroad, has shaken up the financial reform process by proposing and gaining presidential support for the ''Volcker Rule.'' Named for the highly respected former Federal Reserve Board chairman, the rule, among other things, calls for a prohibition against certain proprietary trading activities by depository institutions. On Feb. 1, the day before the former chairman testified before the Senate Banking Committee, BNA's Richard Cowden spoke with Stuart Mackintosh, the Group of 30's executive director, about the rule itself and about the organization's broader set of proposals for reform of U.S. financial standards.

Despite Political Headwinds, Group of Thirty Seeks Adoption of the 'Volcker Rule'

BNA: In recent days, we have been hearing a lot about the Volcker Rule, and the Obama administration's embrace of it as part of a possible solution to the too-big-to-fail problem. Could you summarize it briefly, what the proposal would do?

Mackintosh: The proposal recognizes that certain large commercial deposit-taking banks are so central and important to our financial system that they need to be treated in a different manner from other banks and more risk-taking institutions. Specifically, the Volcker Rule would specify that those commercial banks of systemic importance who receive government guarantees would be prohibited from taking certain risky activities- . . . They would be prohibited from proprietary trading or from managing hedge funds or private equity funds within their banks.

The second part of the rule would suggest that, going forward, size ought to be considered as an issue when looking at the risk associated with major institutions. That is to say that excessive concentration itself can create a risk of too-big-to-fail and we want to get to a point as President Obama said in his remarks on the 21st of January where no institution is viewed as being too big to fail. So it's a two-part rule in essence. First, it restricts the types of activities that large deposit-taking commercial banks can take and secondly, it would bring in size as an issue to be considered, going forward.

BNA: What is the threshold size? Is that expressly mentioned in the rule?

Mackintosh: It is not. The details of that are yet to be thrashed out. However, I would say that it is intuitively reasonable to note that size can be a factor in risk and the ability to manage that risk both as a supervisor and as a private sector institution.

BNA: Some of the comments on the Volcker rule so far indicate that it would in effect reinstitute the provisions of the Glass-Steagall Act. Is that how you view it, and would that be good for the market and the economy?

Mackintosh: We don't view it as going back to Glass-Steagall but we do view it as a sensible response to an analysis of the crisis and the effects of the crisis that we saw in 2008. We're not moving back to Glass-Steagall but we are proposing in this Volcker Rule and in the various steps that are also being considered in Congress as we speak to place these certain limits on the activity of these core financial institutions, these commercial, deposit-taking banks. The precise impact of these restrictions is unclear at the moment but it depends who you talk to. Some people say that it will have a very significant and detrimental effect on the banks concerned, others say no, that may not be the case because the amount of proprietary trading they do is relatively limited already. If that is indeed the case, they ought not to be severely impacted by the rule that says that you are no longer allowed to engage in proprietary trading.

BNA: So it wouldn't be that you're allowed to engage in a little bit of proprietary trading, it would be a prohibition?

Mackintosh: That's right. Let's be clear, you could still transact business for your clients. Under Glass-Steagall you would not have been able to do that at all. Investment bank activities were completely separated from regular banking activities. We're not going back to Glass-Steagall, we're just placing a clear separation between certain activities that commercial banks can and cannot do because we're recognizing that there are fundamental conflicts of interest in allowing one institution to do so many of these activities simultaneously.

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BNA: We understand that the Volcker Rule is already coming under criticism. Are you concerned that it is becoming politicized?

Mackintosh: Obviously major financial reforms of this type are inherently political, because this is a political process. But we don't believe that our recommendations and the Volcker Rules that President Obama supports are political. Not at all. The Group of Thirty is a very broad-based, composed of many senior central bankers, private-sector financiers, and academics from across the world with experience of both private and public-sector activity at the highest level. So the type of recommendations that we promulgate and that Chairman Volcker has promulgated in the report on financial reform are, in fact, we believe very reasonable. They are the sum total of the group's assessment of what is necessary to get back to a degree of stability. So we don't really believe that these are highly political or politicized recommendations. The process is inherently political, of course, but we believe that the recommendations that Chairman Volcker has proposed are reasonable and necessary to return the economy to a properly stable footing, going forward.

BNA: Among the concerns we have heard from Democrats is that the rule would need to clarify what would constitute proprietary trading. Do you think the proposal is clear enough about that, or is that something that needs to be worked out in the legislative process?

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Mackintosh: I think that is right, it needs to be worked out in the legislative process. The precise definitions are a matter of careful concern and need to be worked on, but we were essentially laying out broad principles that we believe should be applied, not just in the U.S. but elsewhere, and it would have been wrong of us, in that process, to get down into the legislative minutiae. It is now up to the administration and Congress to fashion workable regulations that adhere to the fundamental points in those rules and in the other recommendations that we have made in that report and since.

BNA: Has the group or Mr. Volcker been having conversations with leaders of both parties in the Senate about this.

Mackintosh: What I would say is that Chairman Volcker over the last year has had numerous conversations with senior senators on both sides of the aisle and has spoken repeatedly with both bodies . . . [He has] given testimony in the House and the Senate.

BNA: When Volcker speaks people listen, right?

Mackintosh: Right, I think people are looking for somebody to give an unbiased, careful, and prudent assessment of what is necessary to put the financial system on a firm footing and I believe that they do listen when Chairman Volcker speaks because they understand that he is not acting for any particular interest but only out of public interest.

BNA: The Group of Thirty last year developed an extensive set of recommendations for strengthening the financial system. Many of the core recommendations seem to be common sense, such as filling gaps in regulatory regimes and enhancing transparency. How well do they dovetail with the Volcker Rule and the proposed reform legislation?

Mackintosh: Well, we would see them as all part of a package really, we would prefer that these things are looked at in a holistic manner, so that the other recommendations from the January report are part and parcel of our efforts to recommend the steps necessary to reform the system, so there are many pieces, as you say. There is the need to close the gaps in coverage, and we know that the U.S. has many gaps in the ways that differing institutions and products and markets are treated. We also called on policymakers to increase the quality and effectiveness of prudential oversight. We know that many, perhaps most, regulators and supervisors failed in the 2008 crisis, either to anticipate it or deal with it effectively, at least in the first instance. We know that institutional standards need to be strengthened. We make that clear in the report, and that's not just capital standards, liquidity standards, capital buffers and so on. It's also standards within the firms themselves, because ultimately, supervisors and central bankers can only do so much. If the firms themselves don't have the right prudential standards; what we would call a philosophy of self-supervision, we can't make sure that these crises don't happen again. So we were clear about that—the need for governance reforms, including some action on compensation.

Finally, one of the principal drivers of the crisis—if not a driver, then certainly a major contributor to the crisis, was the opacity of financially markets, specifically the over-the-counter derivatives markets, and we have called for those to be cleared through central counter-parties and we see that this is one of the policy planks of the U.S. administration and has been called for in the House bill. And we've pressed hard on that as well. So we believe that the Volcker Rule fits closely with other pieces that need to be put into place.

BNA: The Group of Thirty's recommendations came out over a year ago. Are they still relevant or are some of the circumstances changed enough that some of the recommendations need to be updated?

Mackintosh: I don't think that they have to be updated at this point. I think the lessons and the recommendations we made in January 2009 are still pertinent today. Why are they still pertinent today? Because at this stage, no major reforms have been taken. We have a bill that has passed through the House. We haven't had action yet in the Senate. We need to see these recommendations and the major facets of these recommendations passed into law. It's very notable that the European Union has acted much faster to plug the gaps to address the issues around macro-prudential oversight to address the need for closer supervision of major systemically important institutions. So we're a year

on, but we still don't have a reform package in place. So we don't think these are past their sell-by date. Far from it. I think what you are seeing is an increasing realization that they are indeed necessary steps and we have parts of the solution in the House bill but we need to see what comes out of the senate process and we need to see the Volcker Rules implemented legislatively as well.

BNA: What about the House bill did you see that might be in conflict with the Volcker Rule? Are there any glaring inconsistencies between the house bill and the Volcker Rule?

Mackintosh: Well, actually no. The House bill doesn't address the Volcker Rule specifically . . . but I would note that Chairman Volcker has observed recently that he was concerned about the extent to which lobbying had perhaps watered down some of the proposals within the House bill so that there has to be continued vigilance on the part of the proponents of reform to make sure that the final bill that comes out of conference—after the Senate passes its version—is sufficiently robust and strong to make a real difference. If there are too many exclusions; if the rules aren't clear enough and applied in a consistent fashion, institution to institution and product to product, we won't get the reforms we need.

BNA: Is it futile for the U.S. to adopt comprehensive financial reform if other countries don't follow suit, or on the other hand, it sounds like you're saying we're a little bit behind them in this regard. Is that the case?

What we're seeing at the moment is that there is a great deal of work being done through the [Group of Twenty]—driven through what's known as the Financial Stability Board and other international institutions, including the [International Monetary Fund], to identify the lessons, to deal with the failings of the previous system.

Mackintosh: I think that's right. What we're seeing at the moment is that there is a great deal of work being done through the [Group of Twenty]—driven through what's known as the Financial Stability Board and other international institutions, including the [International Monetary Fund], to identify the lessons, to deal with the failings of the previous system. That would include things like enhanced capital standards for major banks, new liquidity standards, the adoption of a leverage ratio. All of these things are being driven by a group of international policymakers led their political leadership at a relatively fast pace, if you consider the previous major international financial reforms of this scope took 10 years to implement.

BNA: It sounds like you're referring to Basel II, (the Basel Committee on Banking Supervision's policy on capital requirements).

Mackintosh: Right. So if you consider that essentially the starting pistol was April of last year when the G-20 came out with what was a very extensive list of reform goals with tough timelines and deadlines, they already have a series of drafts on compensation policies, on capital requirements, and so on. And now there's a period of discussion and debate, but we expect that within the next couple of years those will come into force. And if you look at the Europeans, they have already acted on the De Larosiere Report, which proposed a series of macro-prudential supervisory changes at the level of the European Union, the creation of new institutions to oversee this; all of those are being put into place. The U.S.? Well, we're getting there but it's slow. We're a year down the line and still we have nothing on the statute books. So you're point about whether the U.S. is lagging, I think if you asked non-U.S. observers, they would almost certainly say yes.

BNA: We're already hearing concerns saying we can't go through with this unless everybody else does the same thing, but you seem to be saying we still have some catching up to do. Would it be fair to say it would be disingenuous to say we can't enact financial reform until everybody else does?

Mackintosh: I think that's right. You have to differentiate here. We understand that each country has its own particular culture and political and economic structures, So, in France for instance, there is a universal banking model. They have a particular financial and regulatory structure. It actually appeared to work quite well in the 2008 crisis. They have various institutions that emerged relatively unscathed, but leave that aside. The U.S. has a very, very complex supervisory structure. We will still have, after the reforms, three major banking regulators, 50 state banking regulators, no regulator of the insurance industry at the federal level and 50 state insurance commissioners, to name only part of the structure we're grappling here in the U.S.

So I think we have to differentiate between the consistent application of agreed international standards—that is to say what does capital mean? How much capital do banks need? How do we measure that capital and how do we apply the rule? You differentiate between that and the structure you happen to have in your country, because no one is suggesting that we will have exactly identical structures of supervision, country to country. That's not going to happen. The French model is different from the British model, which is different from the Spanish model, and so on. So I think it is a little bit of a red herring to say that we can't do anything until we wait for others. As I said in my previous comments on the Financial Stability Board and the Basel process, which is ongoing as we speak, they are already doing it.

BNA: According to the Group of Thirty's recommendations, Fannie Mae's and Freddie Mac's mortgage purchase activities would be ceded to private sector firms, with the government reserving the right to intervene through the actions of a public institution. Where do the GSEs figure into financial reform and the too-big-to-fail problem?

Mackintosh: We made it clear that we felt you need to have a differentiation between the mortgage finance function and the support of the mortgage market by explicit bank backing and financial support. In other words, this is something that will have to be dealt with—we don't expect it immediately. But further down the line there ought to be a recognition that perhaps you shouldn't have a mix of private shareholding func-

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tion and government guarantee of these very, very large institutions.

BNA: Are you concerned that the financial system itself might simply be too big to change? That is, is the system powerful enough to fend off any meaningful attempts to reform it?

Mackintosh: That is the worry—that people will forget. It's remarkable how short memories are on Wall Street. We have a period of, thank goodness, calm and modest economic performance—post crisis—fueled, as you know, by trillions of dollars from the central banks of the world, who stepped in in an unprecedented way to assure the system didn't collapse. So our current prosperity is indeed built on the actions of very tough policymakers who took exceptional measures. But there is a tendency to think, 'Oh, well, what I didn't see, couldn't have happened.' In other words, you never win political kudos for stopping something from taking place. People say, 'I didn't see the financial crisis as being as bad as you said it was.' In the case of the banking fraternity, it may be there is a rush to act as if it's business as usual. 'Why should we bother with all these excessive reforms? The system wasn't broken.' Whereas, we say the system almost was destroyed and it needs stronger regulation to make sure that its tendency to excessive risk, to self-destruction is not allowed to get out of control again. So we don't think it should be business as usual. There is a real danger that that might happen, but it would be a huge mistake if we failed to take action, because you already see in the public policy realm in America now where people are worrying about where the next bubble is going to be. Well, we need to get ahead of that. We need to have structures in place to weather the next bubble better than we did this time. And the only way to do is by passing a series of reasonable financial reforms that will make a difference to the financial system but will, one hopes, a more stable and less volatile system that won't destroy the savings and livelihoods of many millions of people again in the near future.