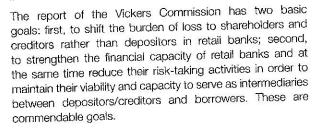
Gene Rotberg

Worries that retail banks might be tempted to take on even more risk to goose returns – unless they get a special deal to ensure their profitability

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The approach to achieving them is:

- to require more capital (10 per cent) for "retail" banks;
- to require more debt;
- to assure priority of depositors over creditors;
- to prohibit lending by "retail" banks to finance investment banking activities (proprietary trading, flash trading, program trading, derivatives, leveraged buyouts etc);
- to prohibit retail banks from engaging in such activities; and
- to require a distinct legal, financial and governance structure for retail banks (apparently with separate shareholders from the parent investment bank) – a socalled "ringfence" from their investment banking arms.



Impact on retail banks

I fear the proposals will work – too well. Yes, the retail banks will be much safer; but my concern is that they will be unable to attract capital or creditors given that they will be restricted to engaging in what have become "commodity" businesses and products with narrow spreads and heavy competition. Potential capital providers, particularly if they represent 10% of the retail banks' liabilities, will be reluctant to invest where there is minimal upside and substantial downside. Indeed, in the United States, that is precisely the reason why Glass-Steagall was emasculated – the retail banks could not compete for capital with investment banks that had a wide variety of products and activities at their disposal.

I am therefore concerned that the retail banks, constrained as they would be, might take even more risks in their lending activities in order to increase profitability and attract capital — a highly unsatisfactory development. They certainly have shown that penchant in the very recent past. Witness their tack of prudence in the residential and commercial property markets. Or, they could simply wind down and therefore no longer be able to meet their capital and debt requirements on one hand and serve as viable financial intermediaries on the other. Moreover, I doubt that their investment banking siblings would find the opportunity of "cross-selling" products to the retail depositor base a sufficient reason to invest capital.

But there are some "solutions". Retail banks might be given the (sole?) capacity to execute agency orders in the stock markets or to serve as investment managers – both relatively low-risk and profitable activities. And/or they might be required to distribute a high percentage of their earnings to shareholders – say 80 per cent, combined with a reduced tax rate for the recipients. There will certainly be more efficiency gains through IT that will help lower the high fixed costs of the retail banks, but I doubt it will be enough to assure profitability without carving out for them some areas that offer decent profits with minimal risk.

Impact on the investment banks

They are in trouble. Their main proprietary activities – trading in all its traditional and arcane forms (derivatives, underwriting,

leveraged buy-outs etc) - will have to be financed either by shareholder capital or debt from sources other than deposittaking institutions. That is probably the most far-reaching recommendation of the Commission - and I believe a good one. It will substantially constrain those activities that have doubtful public purpose or utility and that are fraught with risk. It was always dangerous to have a system where depositors in banks, which were government (taxpaver) insured, finance the most risky products and activities of investment banks. Essentially, we privatised the asset side of their balance sheets and nationalized the liability side - a dangerous and unwise policy. The Commission's proposal will return the investment banks to their situation before they went public - having to rely on their own capital. Yes, they will still be able to borrow (and leverage their proprietary activities), but not from banks. That will considerably reduce risk-taking for their more esoteric and proprietary products. And, frankly, I think that is a salutary development. Yes, investment banks provide valuable services. But, given the scandals - Merrill Lynch, Salomon Brothers, Enron, Barings, Orange County, LTCM, Societé Generale, Daiwa, Sumitomo, UBS, etc - I believe they cannot meet the burden of proof to justify why their proprietary activities should be financed by taxpayer-guaranteed deposits.

Investment banks will argue that their proprietary activities are the cement that holds the market together; they are the providers of liquidity, liquidity, liquidity – the argument heard each time regulators seek to constrain or regulate their activities.

While there is not space here to argue the point fully, it is relevant to note that liquidity, even assuming that proprietary trading increases it, is a mixed blessing. The quicker one can liquidate an obligation, the less attention to prudence in assuming the risk in the first place. Moreover, there is no evidence that markets now are less volatile than decades ago when volume was a fraction of today. No, flash traders are surely not "market makers" providing liquidity in opposition to a prevailing trend. And, given the tremendous growth of venture capital funds and private equity, where investments are typically held for five to ten years, involving hundreds of billions of dollars (or euros), we should give pause in arguing that the "market" demands immediate liquidity. But whatever

the arguments for the advantage of proprietary trading, computer trading, leverage, derivatives, flash trading, the use of complex algorithms for trading – call it what you will – the issue is not whether, on balance, these products and activities do more harm than good to our society but whether, given their history, they should be financed by and their risks borne by government-insured deposits, or by the private sector. To me, the answer is clear. The Commission has it right. And lest we forget, it was not too long ago that all investment banking and proprietary trading was done by essentially private partnerships, with no public capital.

The issue of sovereign debt

Notwithstanding everything above, there is little doubt that the "retail" banks – on their own and without the help of investment banks – have managed on many occasions to screw up big time, the latest example being sovereign debt. Their imprudent lending to developing countries in the 1970s and 1980s has been repeated in the past 10 years by lending to eurozone countries. The regulators and the rating agencies missed it. And unlike the complexity of derivatives (about which the regulators have still only a passing, trivia: expertise), this was simple stuff that had (and still has) the potential to do great damage to the global financial system. And, given continuing government deficits, the potential for damage by contagion is great.

I propose a modest "solution". Retail banks – those with government-insured deposits - should not be permitted to lend or hold the bonds of any government other than their own. If governments cannot finance their deficits domestically and must borrow "abroad", they have the capacity to borrow from central banks, sovereign wealth funds, the IMF, the World Bank, other international financial institutions, pension funds (government and private), a huge array of institutional funds, managed funds, hedge funds, investment banks all over the world etc. That's enough. "Retail" banks outside their country need not and should not be one of the lenders of last resort of sovereign debt.

Yes, as you can tell, I have always been and still am a "grum $\mathfrak{g}_{\mathbb{R}}$ old man."