



Daily Themes

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Banking under the Volcker Rule

Like the winter snow, last week's proposed clampdowns on Wall Street by the Obama administration were a timely reminder that although recession has passed, it has left potholes in the road to recovery. While Obama's plans could slow the speed of growth, we don't believe they will cause significant damage.

Banks share prices have fallen in the US and around the globe, as uncertainty again surrounds the sector. These concerns are impossible to verify or disprove, as bank reforms are subject to a political decision-making process that is not within the control of any individual, administration or even country. The current proposals would further increase the cost of capital for banks, but do not significantly damage the industry. They also address some of the regulatory shortcomings exposed by the 2008 collapse of Lehman Brothers.

President Obama's proposed "Volcker Rule" would mean US banks will not longer be allowed to own hedge funds, private equity funds or proprietary ("prop") trading operations for their own profits, rather than on behalf of their customers. This was combined with a proposal to limit further consolidation of the financial system by putting a cap on the maximum proportion of total liabilities that can be controlled by a single bank, augmenting current limits on market share of retail deposits. It also reflects a previous proposal to impose a charge on wholesale deposits, to go alongside the existing retail deposit-protection insurance. Funds raised would cover the cost of bailing out the US financial system following Lehman's collapse.

The political element of this announcement should be clearly recognised. It coincided with Goldman Sachs reporting profits soaring to \$13.4bn in 2009, from a "mere" \$2.3bn in 2008. It comes on the heels of the loss for Obama's party of a critical seat

in the US Senate, which threatens to derail Obama's flagship healthcare reform legislation.

The proposals were also lacking in detail, and there is much negotiation to come. Obama faces new limitations on his ability to push through his agenda, let alone dictate global financial regulation. The proposals could be rejected, but equally there is a risk that they could 'snowball' into even more far-reaching changes in the financial industry.

If authorities were focused on saving the financial system in 2008 and ensuring that banks had sufficient capital in 2009, then the focus for 2010 is greater banking regulation. Now that profitability has returned to the sector, there is scope to impose new restrictions. Banks' share prices and financial markets in general have reacted negatively to the prospect of regulation that would restrict profitability and could also harm competitiveness.

However, the Volcker Rule and related proposals are relatively limited. We estimate that ending proprietary trading would, on average, cut less than 5% off trading-related earnings and an even smaller proportion of most banks' total profits. The limits on market share may simply prevent further consolidation by the largest banks. The 0.15% levy on wholesale funding may hit some markets, but the intention is to reduce the extent of large scale, short-term funding on thin margins that was behind some of the worst excesses of the last crisis.

The proposals are likely, at the margin, to further increase the cost of capital for banks and hence for borrowers. But there is nothing in the current proposals that would significantly damage the financial industry. Restrictions on profitability must be balanced against measures to improve the stability of the industry. Overall, the proposals are a timely reminder that 2010 will not simply see a return to the boom years, and the recovery will be restricted by the nature and severity of the crisis that preceded it.

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