Obama Bank Plan – Glass Steagall Redux

It sounds like a plan. President Obama in an effort to address what is widely believed to be a flawed banking model has decided to ressurrect the Glass Steagall Act 1933. Glass Steagall 1932 had already been effectively revived, extended and implemented in 2008 as the Fed rode to the rescue of a banking system on the verge of collapse. It is perhaps ironic that a year prior to the crisis of 2008 Hank Paulson was in China extolling the benefits of a market economy. A year later banks are being de facto nationalized in the Western world. It is worth pointing out that Chinese banking regulation maintains a Glass Steagall type separation between commercial and investment banks even today.

Obama's plan stops short of calling for a reinstatement of Glass Steagall. Instead "banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds or proprietary trading operations for their own profit, unrelated to serving their customers," The plan has the fingerprints of ex Fed Chairman Volcker, it is being informally referred to as the Volcker Rule. Larry Summers on the other hand has pointed out that the victims and perpetrators of the crisis had been investment banks and insurance companies which would not have been impacted by Glass Steagall in the first place.

Great plans are often precipitated by great crises (Glass Steagall itself was enacted in the wake of 1929 and the Great Depression), and driven by populist politics. In many ways, the Obama plan is a reaction to the profiteering of Wall Street in the wake of the 2008 crisis. Financed with public funds, aided and abetted by the Fed, Wall Street firms profitted handsomely in the recovery of 2009 much to the ire of taxpayers. The decisions of banks to pay out large bonuses on their 2009 profits added further fuel to the fire.

Injudicious management of public relations must certainly be a factor in teh banks being complicit, albeit unintentionally, with the Obama plan. One possible if unintended consequence could be that the likes of Goldman Sachs and Morgan Stanley decide to abandon their bank holding company status, and get back to business pre 2008 style, an extrapolation of the Lucas Critique.

Assuming that the plan is approved, how will it be implemented? Commercial banks are nothing more than intermediaries between savers and borrowers, they are pooling vehicles, hopefully well managed, managing the risks on either side of their balance sheets, deposits on one side and loans on the other. Investment banks are also nothing more than intermediaries with the same balance sheet management issues. The separation of commercial and investment banking activities requires some thought and care in definition. What is a hedge fund? More importantly, what is prop trading? Is extending a loan prop trading? Is participating in a loan syndication prop trading? Is buying a loan in the secondary market prop trading? How about a bond, or a convertible bond, or a preference share, or common equity? Shall we exclude FX transactions? What is considered a hedging transaction? Basel already prescribes a risk based framework to capital management. But how about a risk based approach? How risky is a bilateral loan marked on a hold to maturity basis versus a liquid corporate bond? How risky is a MBS versus a project finance for an emerging market infrastructure project?

Another question is how able are the regulators at matching wits with investment bankers? Profit participation loans to SPVs, total return swaps on hedge fund returns, rated tranches of collateralized hedge fund obligations… Let’s not go there.

What will happen? Looks like either Morgan Stanley abandons the bank holding company status and reverts to being an investment bank or it will have to sell Frontpoint and fire a whole bunch of traders. If the Obama plan passes into law

banks will have no choice but to separate into investment and commercial banks. That’s assuming that the plan has better definition of what constitutes prop trading. The affiliated hedge funds will have to go. Morgan Stanley and Goldman Sachs are likely to de-bank and revert to the hedge funds they used to be.

Not every bank will have the luxury of de-banking, not every bank will cleave into two. Some will jettison their prop desks, hedge funds and buy out divisions. For these traders, the writing is on the wall. The supply of hedge funds and private equity GPs is likely increase. If one looks at current conditions in the hedge fund industry the capital raising prospects are not great, but they are improving. By the time the Obama Plan is in implementation, hopefully the capital raising environment will have improved.

For the hedge fund seeder, the supply of talent will increase. However, any seeder wanting to make a go of it will have to provide marketing as well as capital.

For the hedge fund allocator, there will increased choice. This is always a good thing. For the lazy allocator, this is not such a good thing.

For the regulator, if capital turns to meet the supply of talent, a greater pool of capital will fall outside of Basel II and bank capital management rules. Nice work chaps. The risk is an attempt to regulate hedge funds in more granularity which will play into the hands of Geneva, Hong Kong and Singapore.

For market efficiency, the number of independent, less constrained decision makers rises, which again always is a good thing.

For the trader, it is forced independence. An anecdote from the fashion industry: Donna Karan had to be fired from Ann Klein before she surpasssed her old employer.

For the investor, there will be some element of a false sense of comfort, that regulation has addressed a flaw and that the level of due diligence the individual needs to perform needs not be stepped up. This is the risk with all efforts at tighter regulation. It breeds complacency and sows the seeds of the next calamity.

The Obama Plan, the Volcker Rule, Glass Steagall II, call it whatever, is neither good nor bad. What we know from history is that human’s will react to policy in their own interests and so very often confound it.