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Regulators Resist Volcker Wandering Warning of Too-Big-to-Fail

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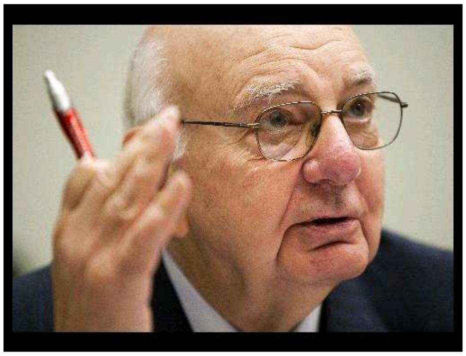
By Gadi Dechter and Alan Katz



Dec. 15 (Bloomberg) -- **Paul A. Volcker** visited nine cities in five countries in the past eight weeks to warn that bankers and regulators "have not come anywhere close to responding with necessary vigor" to the worst economic crisis in 70 years.

"There is a lot of evidence that financial weaknesses brought us to the brink of a great depression," Volcker, 82, said Dec. 8. at a conference in West Sussex, England. He told executives there that the changes they've proposed are "like a dimple."

Two years after the start of the deepest recession since the 1930s, no U.S. or European authority has put in force a single measure that would transform the financial system, based on data compiled by Bloomberg. No rule- or law-making body is actively considering the automatic dismantling of banks that Volcker told Congress are sheltered by access to an implicit safety net.

There's little evidence that policy makers are heeding Volcker, the former chairman of the U.S. Federal Reserve. More than 50 regulatory overhaul proposals have been submitted in the U.S. and Europe, the data compiled by Bloomberg show. Lawmakers and regulators have debated new rules for capitalization and leverage, central clearing for derivatives trading, oversight of hedge funds and ways to monitor systemic risk.

While the U.S. House of Representatives has approved a financial regulation bill, authorities in the U.S. and Europe have sidelined measures that would automatically force changes in the structure of financial companies that Bank of England Governor **Mervyn King** called **"too important to fail."** Volcker is leading a chorus arguing for restricting the size or primary functions of financial institutions.

Volcker's Travels

"He is spot on," Joseph Stiglitz, a Columbia University professor who won the Nobel Prize in economics in 2001, said in an e-mail.

Volcker, who heads President Barack Obama's **Economic Recovery Advisory Board**, told Kentucky's Georgetown College students "we need to produce more, finance less," according to the school's Web site, and said in Bonn that some banks have "pervasive conflicts of interest." In Berlin, he told Bloomberg television that "this isn't any time to go back to business as usual."

After Volcker became chairman of the Federal Reserve in 1979, he restricted the money supply, forcing **interest rates** to 20 percent to break an inflationary surge. Following the recession that ensued, President Ronald Reagan nominated Alan Greenspan in 1987 to replace Volcker, who had succeeded in driving the inflation rate to 1.1 percent by the end of 1986.

Dubai, China

A new debt crisis may threaten the economy before regulatory changes are enacted, according to **Simon Johnson**, an entrepreneurship professor at Massachusetts Institute of Technology in Cambridge and a former International Monetary Fund chief economist. Most of the world's large international banks continued to expand as stock markets plunged and credit froze last year, data compiled by Bloomberg show.

After Dubai, the second-biggest sheikhdom in the United Arab Emirates, said Nov. 25 that it might delay debt payments by a development unit, analysts questioned whether the European Union would back Greece's debt, roiling Greek stocks and bonds. Abu Dhabi promised yesterday to help the Dubai unit avoid defaulting. In China, a 4 trillion yuan ($585 billion) stimulus package, five interest rate cuts since September 2008 and $1.35 trillion in lending this year may lead to an asset bubble, according to Erwin Sanft, head of China and Hong Kong equities research at BNP Paribas SA.

"Making meaningful regulatory changes is urgent now because this is the window of opportunity," MIT's Johnson said in an interview. "If that window closes, we're asking for trouble."

Resolve Fades

U.S. and European governments' $15 trillion of guarantees, cash injections and other financial industry support, based on Bank of England data, may have been too successful. After Obama and other leaders opened 2009 promising sweeping financial overhaul, credit thawed, markets rebounded and resolve for "fundamental reform" faded, according to Susan Hoffman, a professor of political science at Western Michigan University in Kalamazoo and author of the book "Politics and Banking: Ideas, Public Policy, and the Creation of Financial Institutions."

Bloomberg News interviewed lawmakers, investors, economists, analysts and academics from 11 countries and reviewed draft laws and rules in the U.S. and Europe, the epicenters of the crisis of 2007-2008. The measures included those by members of executive or legislative branches in the U.S. and EU and by the Basel **Committee on Banking Supervision**, which recommends standards for financial institutions for 27 countries including the U.S., Russia, Japan and Brazil.

State of Play

The survey found that most of the more than 50 proposals are still being debated. Among at least 14 adopted are limits on banker pay in France, the U.K, and the Netherlands; more stringent testing of banks' ability to withstand losses in Germany; and tougher capital rules in Switzerland.

In the U.S., Congress isn't likely to pass final legislation until next year, as Obama and the Democratic leadership have made health-care overhaul the top priority and lawmakers face resistance from Wall Street banks, hedge funds and the U.S. Chamber of Commerce. Financial companies historically are the largest donors to congressional election campaigns, according to the Center for Responsive Politics in Washington.

House Bill

The House voted 223-202 Dec. 11 to approve a package assembled by the Financial Services Committee. The bill would heighten consumer protections, expand oversight of hedge funds and derivatives and set up a mechanism to allow -- without requiring -- regulators to dismantle large firms whose failure could threaten the economy. The Senate is writing its own law.

"The House of Representatives has acted to leave the age of dishonesty, recklessness and irresponsibility behind," said Speaker Nancy Pelosi, a California Democrat, after the vote.

The European Commission, the EU's executive arm, has proposed a **European Systemic Risk Board** similar to authorities being considered in the U.S., with the power to warn national regulators of risks. EU bodies are also developing rules on derivatives, **hedge funds** and bank capital.

Asia accounted for 2.5 percent of the $1.71 trillion in losses and writedowns by banks and insurers during 2007-2008, data compiled by Bloomberg show. Regulatory overhaul steps by Japan include expanding financial inspections of insurance and securities companies. China asked its biggest banks to increase capital ratios to at least 11 percent from 10 percent. The minimum set by the Basel committee is 8 percent.

Great Depression

Governments worldwide need to work together to implement roughly the same solutions at about the same time, or financial companies may move their operations to the countries with the least stringent rules, regulators said in interviews.

To be sure, restructuring in the U.S. during the Great Depression came together years after the 1929 stock market crash. Congress took until 1933 to create the Federal Deposit Insurance Corp. and 1934 to establish the Securities and Exchange Commission. Now lawmakers are attempting to reverse three decades of deregulation.

"This is one time when you hope they move slowly," said **Bert Ely**, the head of Ely & Co., a bank consulting firm in Alexandria, Virginia, in an interview.

Protecting the economy from another catastrophe is important enough for lawmakers to take their time, said Ely, an adjunct scholar at the Cato Institute, a Washington research group, who has testified before Congress.

"You've got to get it right the first time," he said.

HSBC's Green

New regulations might slow economic expansion, according to **Stephen Green**, chairman of London-based HSBC Holdings Plc.

"If all of the measures currently under discussion with regard to strengthening the financial system came in their most extreme form and all too quickly, there is no question in my mind that this would damage the recovery," Green said in a Nov. 17 speech in London.

The countries belonging to the Basel committee will probably agree next year on tougher capital, liquidity and leverage requirements for banks, members said. Implementation will take longer and depend on economic recovery, they said.

The measures would substantially increase amounts that banks have to set aside against emergencies, potentially reducing their lending ability, according to **Josef Ackermann**, chief executive of Frankfurt-based Deutsche Bank AG.

Antitrust regulators forced asset sales at bailed-out companies, such as the U.K.'s Lloyds Banking Group Plc and Germany's Commerzbank AG. Still, European banks are emerging from the credit crisis bigger than before, according to data compiled by Bloomberg. The data show European bank assets grew 25 percent since January 2007, compared with a 20 percent rise at U.S. lenders.

'It's Insanity'

Four U.S. institutions -- Bank of America Corp., Wells Fargo & Co., JPMorgan Chase & Co. and Citigroup -- held 35 percent of the country's deposits on June 30, compared with 28 percent by the four biggest two years before, according to the FDIC and the Fed. The world's 10 largest banks at the end of 2008 had 26 percent of the assets of the top 1,500 banks, up from 18 percent in 1999, Bloomberg data show.

"It's insanity that the too-big-to-fail institutions are even bigger today than they were," said U.S. Senator **Bernie Sanders**, a Vermont independent, in an interview. "God forbid we have another financial crisis."

Governments should separate deposit-taking banks from those that use their own money to trade and issue securities, said **Irving Kahn**, 103, who has worked on Wall Street since 1928.

Reed's Apology

"I wouldn't lend you a dime if I knew you loved to gamble at a casino," said Kahn, the chairman of investment advisers Kahn Brothers Group Inc., in an interview.

John S. Reed, the former co-chief executive officer of Citigroup Inc., regrets helping to engineer the merger that created the bank, he said. Citigroup, which took $45 billion in U.S. aid under the Troubled Asset Relief Program, said yesterday that it will repay $20 billion.

"I'm sorry," Reed, 70, said in an interview. U.S. lawmakers were wrong in 1999 to repeal the Depression-era Glass- Steagall Act, he said. The act required the separation of institutions involved in capital markets from those engaged primarily in traditional customer services, such as taking deposits and making loans.

Resurrecting Glass-Steagall would reduce the need for the taxpayer bailouts that added between 9 percent and 49 percent to the profits of the 18 biggest U.S. banks in 2009, according to **Dean Baker**, co-director of the Center for Economic & Policy Research in Washington.

Europe's Universal Banks

Another school of thought is that outlawing institutions of a certain size or laying down universal caps on securities trading by retail banks would be impractical, ineffectual and a potential drag on growth, politicians and regulators in charge of rule-writing in the U.S. and the EU said in interviews.

"Plenty of firms got into trouble making regular commercial loans, and plenty of firms got into trouble in market-making activities," Fed Chairman **Ben S. Bernanke**, 56, told the Economic Club of New York on Nov. 16. "The separation of those two things per se would not necessarily lead to stability."

In continental Europe, most regulators say they see little reason to break up so-called universal banks -- such as Deutsche Bank, HSBC and BNP Paribas -- largely because they have withstood turmoil. HSBC didn't take the U.K. government's offer for aid, and Deutsche Bank never tapped Germany's bank-rescue fund. BNP took 5.1 billion euros as part of a program to provide funds to banks in exchange for an increase in lending. The bank raised 4.3 billion euros in a rights issue in October 2009 to reimburse the government.

Fisherman's Patience

"The crisis didn't come from here," said **Daniele Nouy**, secretary general of the Commission Bancaire, France's bank regulator. "We think our model, with universal banks and a single, strong regulator, works well."

The nascent economic recovery represents a serious threat to the overhaul of financial regulation, according to Representative **Brad Miller**, a North Carolina Democrat on the House Financial Services Committee.

"My greatest fear for the last year has been an economic collapse as bad as the Great Depression," Miller said in an interview. "My second greatest fear was that the economy would stabilize and begin to recover and the financial industry would have the clout to defeat the fundamental reforms that our nation desperately needs. My greatest fear seems less likely, lately, but my second greatest fear seems more likely every day."

With a fisherman's patience, Volcker said he may eventually get his way on financial regulation. He took a break from his efforts in July, fly-fishing in New Brunswick's Restigouche River. He landed a 28-pound Atlantic salmon, according to his staff.

"I'm not alone in this," Volcker said at the Dec. 8 conference. "I think I'm probably going to win in the end."

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