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## Obama Bank Plan's Impact Rests on How to Define 'Client' Trades

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By Bradley Keoun and Christine Harper

Jan. 21 (Bloomberg) -- The impact of President Obama's plan to limit risk-taking by banks hinges on how strictly regulators define proprietary trading at firms including Goldman Sachs Group Inc. and JPMorgan Chase & Co.

Goldman Sachs, which generated at least 76 percent of 2009 revenue from trading and principal investments, gets the "great majority" of transactions from customers, according to Chief Financial Officer David Viniar. About "10-ish percent" of the New York-based firm's revenue comes from "walled-off proprietary business that has nothing to do with clients," he said.

"If a client wants to sell us a security, we'll buy the security," Viniar said today on a conference call with reporters. "That risk, which is principal risk, ends up on our balance sheet. It's the great bulk of what we do all day long in all of our products for all our clients."

The plan to curb proprietary trading at banks is among several proposals that Obama said today will strengthen the U.S. financial system and help prevent a repeat of the credit crisis. Other proposals would prohibit banks from investing in hedge funds and private companies and put new limits on banks' borrowings, according to the White House.

JPMorgan Chase, Goldman Sachs, Citigroup Inc. and Bank of America Corp. tumbled more than 5 percent in New York trading, leading the S&P 500 Financials Index down as 3 percent, its biggest decline since October. All the banks are based in New York except for Bank of America, which is in Charlotte, North Carolina.

### Volcker's Push

Obama said he wants to protect taxpayers from further bailouts, such as those provided through the \$700 billion Troubled Asset Relief Program, passed under former President George Bush in late 2008. Obama voted for the program.

He said he also wants to make sure banks don't "benefit from taxpayer-insured deposits while making speculative investments." Obama stopped short of calling for a reinstatement of the Depression-era Glass-Steagall Act, which before its repeal in 1999 banned the mixing of commercial banking and securities business.

"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," Obama said. He spoke at the White House, standing next to 82-year-old Paul Volcker, the former Federal Reserve chairman who's now advising the administration and has spoken on the need to limit risk-taking at deposit-funded banks.

### Morgan Stanley

"If financial firms want to trade for profit, that's something they're free to do," Obama said. "Indeed, doing so responsibly is a good thing for the markets and the economy. But these firms should not be allowed to run these hedge funds and private-equities funds while running a bank backed by the American people."

The White House defines proprietary trades as those not done for the benefit of customers, according to a senior administration official. Regulators would have the power to ask banks whether certain trades are related to client business, the official said. If they're not, the regulators could order firms to exit the positions.

Morgan Stanley, which lost \$1.05 billion on principal investments last year on top of \$4.15 billion in 2009, has mostly shut down trading operations it deems "proprietary," Chief Financial Officer Colm Kelleher said on a conference call this week.

### 'Integrated' Trading

"We monitor risk across all of the businesses and my view is, we're in a risk-taking industry," Kelleher said.

"If you're a money center bank and you engage in global businesses, you need proprietary trading to offset the risk that you're exposing yourself to when you're serving your clients," said Peter Sorrentino, a senior portfolio manager at Cincinnati-based Huntington Asset Advisors, which oversees \$13.8 billion. "You don't know when you cross that line and get into proprietary trading."

Goldman's Viniar made that point today when discussing the firm's private-equity business and trading operations that are clearly proprietary.

"It's very integrated," he said on a conference call with investors today. "There are a lot of our very important clients invested in our business. We invest alongside other clients of the firm and we invest in clients to help them grow."

#### 'Central to Economy'

Risk-taking on behalf of clients is "basic to the operation of the securities markets" and "central to our economy," said Bruce Foerster, who left Lehman Brothers Holdings Inc. as a managing director in 1994 to found Miami-based South Beach Capital Markets.

"Investment banks traditionally, among other things, were suppliers of secondary market liquidity to institutional investors," Foerster said. "That often required using the firm's balance sheet to fill one side of the trade if there wasn't a natural buyer. That's a function the public mostly does not understand."

Citigroup had to get a \$45 billion bailout after a record \$28 billion 2008 loss that stemmed from subprime-mortgage-related "collateralized debt obligations" and other investments made at least partly to facilitate customer business. Last year, Citigroup generated at least \$3.93 billion of revenue from principal investments, or about 5 percent of overall revenue, according to the bank's financial statements. In 2008, it lost \$22.6 billion in that area.

#### Citigroup's Phibro Sale

"Commercial banks that originate mortgages are still going to have to have a prop desk because they're going to have a mortgage book," Foerster said. "They've got to protect themselves. And they need to have a secondary fixed-income trading operation to know what's going on in the mortgage market."

Last October, Citigroup sold its Phibro LLC energy-trading business, which operated independently from the bank's main trading desk and had brought in average pretax earnings of \$371 million during the past five years. At the time, the bank said in the statement that the sale was "consistent with Citi's core strategy of a client-centered business model." Citigroup's "client-facing" commodities trading business wasn't affected, according to the statement.

Stephen Cohen, a Citigroup spokesman, declined to comment.

JPMorgan Chase derived \$9.8 billion of revenue from principal investments in 2009, or 9.8 percent of the overall, according to its financial statements. The prior year, the bank lost \$10.7 billion on principal investments. Bank spokesman Joseph Evangelisti declined to comment.

#### Rules May Loosen

Even restrictions on proprietary trading may be loosened as the bill wends through Congress, Mark Calabria, director of financial regulation studies at the Cato Institute in Washington and a former aide to senior banking committee Republican Senator Richard Shelby of Alabama, said in a Bloomberg Television interview.

"It's very easy for the president to go on TV and shake a fist," Calabria said. "Ultimately, this will have to be worked out by Congress and it will likely get watered down by Congress and we're not going to see a real solution."

While the Obama proposal may create "negative headlines" for banks, KBW Inc. analyst Brian Gardner said in a report today he was "skeptical that any rules that Congress might enact would make significant dents into current prop trading activities."

#### Grandfathering Seen

"We expect some current activities could be grandfathered or the limits would be set high enough so that banks' current activities would meet the new requirements," Gardner wrote.

Securities firms that converted to bank-holding companies during the financial crisis might simply decide to "de-bank" if the Obama trading restrictions are too onerous, said Larry Kaplan, an attorney at Paul Hastings Janofsky & Walker LLP in Washington who specializes in bank regulation. Goldman Sachs and Morgan Stanley obtained the status partly to gain access to low-cost Federal Reserve funding.

"There's a process in which you can de-bank, which means you have to get rid of your bank," Kaplan said. "There could be an ironic outcome by restructuring these guys back to the way they were pre-crisis, which I'm sure is not the intended outcome."

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--With assistance from Mark Crumpton, Michael J. Moore, Elizabeth Hester, Linda Shen and Josh Fineman in New York and Ian Katz in Washington. Editors: Alec McCabe, Steve Dickson.

To contact the reporters on this story: Bradley Keoun in New York at +1-212-617-2310 or bkeoun@bloomberg.net; Michael J. Moore in New York at +1-212-617-6919 or mmoore55@bloomberg.net

To contact the editor responsible for this story: Alec McCabe at +1-212-617-4175 or amccabe@bloomberg.net.

