

*New Federal Initiatives Project*

**President Obama Proposes Size and  
Activities Limits for Financial Institutions**

**By  
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President Barack Obama's January 21, 2010 announcement that his Administration would seek to limit both the activities and size of U.S. financial institutions (the "Obama Proposal")<sup>1</sup> immediately generated a burst of media and political commentary both in the United States and abroad. It was also followed by a significant drop in the share prices of many U.S. and European financial institutions. The Obama Proposal, which will need to pass both the Senate and House to become law, is virtually certain to generate intense debate in Congress this spring. Senator Richard Shelby and other Senate Banking Committee members have already sent a letter to Chairman Christopher Dodd requesting hearings on the Obama Proposal.

This memorandum describes how the Obama Proposal compares to the Glass-Steagall Act, existing law and other proposals, such as the Wall Street Reform and Consumer Protection Act of 2009 (the "House Bill")<sup>2</sup>, passed by the U.S. House of Representatives on December 11, 2009, the approach being taken by the United Kingdom's Financial Services Authority (the "FSA"), and the "narrow" banking concept being advocated by Mervyn King, the Governor of the Bank of England.

## **Activities Restrictions**

### ***The "Volcker Rule"***

Described with only the highlights of a press release, and supplemented by television appearances by the Obama economic team, it appears the proposal would prohibit U.S. banks, thrifts, bank holding companies and other depository institution holding companies from owning, investing in or sponsoring hedge funds, private equity funds and proprietary trading operations for their own profit, "unrelated to serving customers."

President Obama has called this the "Volcker Rule" after former Federal Reserve Chairman Paul Volcker, who has vocally advocated this division. Financial institutions would be forced to choose between owning an FDIC-insured bank or thrift that has ready access to emergency liquidity through the Federal Reserve's discount window and engaging in these investment and trading activities in a manner that is unrelated to serving customers. This prohibition would apply to covered financial institutions irrespective of their size.

The Obama Proposal would outlaw activities that are currently permissible for U.S. financial holding companies and widely engaged in by major global financial institutions around the world. Under existing law, U.S. bank holding companies that elect to be financial holding companies are permitted to engage in activities that are "financial in nature," including proprietary trading and, within the limits of the Federal Reserve's merchant banking rule, investments in private equity funds and hedge funds.

The Administration's rationale for the prohibition is that financial institutions are using the federal safety net, that is, insured deposits, to fund proprietary trading, hedge fund and private equity activities. The Administration also argues that these activities tend to create "unmanageable conflicts of interest" with the firms' customers. These arguments are strikingly similar to those used to support the Glass-Steagall Act, before its prohibition on affiliations

between banks and firms engaged in securities underwriting and dealing was repealed.

Neither “proprietary trading” nor “unrelated to serving customers” is defined in the Obama Proposal. In a television interview, Larry Summers, the head of the National Economic Council, described the proposal as limiting proprietary trading that has “nothing to do with customers” and restricting a bank’s ability to “operate” private equity and hedge funds. The definition of these terms, either at the legislative stage or a later regulatory stage, will be critical in framing the scope and impact of the proposal. It appears that the Volcker Rule is not intended to preclude customer-driven transactions such as securities underwriting, dealing or market making; hedging customer risk; riskless principal, brokerage or other essentially agency transactions; or customer facilitation. However, it appears to cover “walled off” proprietary trading and principal investments in private equity or hedge funds that are “unrelated to serving customers.”

That said, drawing bright lines between permissible and impermissible activities may pose challenges. For example, does the Administration intend to prohibit proprietary trading in U.S. government or agency securities, foreign exchange or precious metals, which have always been quintessentially bank-eligible activities? Would an otherwise prohibited activity be permissible if conducted in a separate company that does not have access to the discount window and is not funded by insured deposits, where any conflicts of interest are adequately disclosed, and where any insured depository institution affiliates are fully insulated from the risks of such activity?

Various commentators have also questioned whether the proposal is addressing a real problem, since it is widely acknowledged that the prohibited activities did not cause the financial crisis. Other commentators have questioned whether it makes sense to distinguish between financial institutions that have insured depository institution affiliates and those that do not. They have noted that several large “interconnected” financial institutions were rescued or otherwise provided financial assistance during the recent financial crisis for systemic risk reasons, even though they had no material insured depository institution affiliates.

Many questions remain unanswered by the announcement of the proposal. There is no discussion in the proposal of transition or grandfathering of current activities, House Financial Services Chairman Barney Frank has announced his support for a 3 to 5 year transition period during which firms would be required to conform their activities to the new limitations. There has thus far been no consideration of the impact of these activities on the economy, the impact on diversification of U.S. financial institution revenue sources, and whether and to what extent the prohibition could advantage investment banks and other financial institutions that are not insured depository institutions or depository institution holding companies. Also not described was whether and to what extent U.S. financial firms could engage in such activities in separately capitalized subsidiaries outside of the United States or what impact the Volcker Rule will have on foreign banks with U.S. operations.

### ***Current Regulatory Authority to Impose Activities Limits***

It is not widely understood that federal banking regulators already have the discretionary authority to impose many of the activities restrictions that would be mandated by the Obama Proposal. For example, under existing law, the Federal Reserve may require a bank holding

company or a financial holding company to terminate any activity or divest control over any subsidiary if it has reasonable cause to believe that the activity or subsidiary constitutes a “serious risk to the financial safety, soundness or stability of a subsidiary bank.” In addition, the Federal Reserve could use its cease and desist powers to require a bank holding company to terminate its activities, rescind existing contracts or dispose of assets. Under current law, these powers, which have been rarely used, are applied on an individual basis to banks and bank holding companies, not on an industry-wide basis.

### ***Not Reinstating Glass-Steagall***

As announced, the Obama Proposal would not reinstate the securities underwriting and dealing restrictions of the Glass-Steagall Act as some in Congress have been supporting. Instead, it would impose a different set of activities restrictions aimed at today’s marketplace.

### ***Impact on Business Models***

Shortly after President Obama’s announcement, Treasury spokesman Andrew Williams stated that Treasury is drafting legislation for the proposal and specified that they will include a provision that gives banks the explicit choice to exit the bank holding company regime. Treasury Secretary Timothy Geithner indicated that the Obama Proposal would undergo some changes in the legislative drafting process, stating, “Banks will have some choice about how they comply with this . . . . And we’re going to work very carefully with the Congress and the regulators to make sure we do this in a sensible way.”

### ***Legislative Context: Integration with the House Bill***

The Administration intends to work with House and Senate lawmakers to incorporate the proposal into the financial reform legislation coming out of Congress. The Administration’s press release notes that the House Bill already authorizes regulators to restrict or prohibit large firms from engaging in “excessively risky activities.”

While the House Bill provides three separate tools for restricting activities, none of them is as broad as the Obama Proposal:

- **Break-up of super-systemically important firms, or the “Kanjorski Amendment”:** Under a provision added by Representative Paul Kanjorski, the systemic risk regulator must take mitigating actions, which may include forced asset sales or break-up, after a determination that a systemically important company’s size or the scope, nature, scale, interconnectedness or mix of activities poses a “grave threat” to the financial stability or economy of the United States. The “grave threat” requirement of the Kanjorski Amendment is a much higher standard than the Obama Proposal and the requirement that it be applied on a firm-by-firm basis, with the opportunity for notice, comment and judicial review, is much more finely tailored than the Obama Proposal. Moreover, under the Kanjorski Amendment, regulators are specifically required to consider the competitiveness of the U.S. financial sector in deciding to order any sort of break-up.

- **Proprietary trading by systemically important firms:** The Federal Reserve may prohibit a systemically important firm from engaging in proprietary trading upon a determination that proprietary trading poses an “existing or foreseeable threat” to the safety and soundness of the company or to the financial stability of the United States. Proprietary trading is loosely defined as trading in financial instruments for a company’s own account and would likely be further defined by regulation at a later stage.
- **Regulation of any systemically-risky activities by all regulated firms:** Federal regulators would have the power to regulate systemically risky activities whether or not the firm itself is systemically important. Generally, after a determination that the conduct, scope, nature, size, scale, concentration or interconnectedness of a financial activity or practice could threaten the stability of the financial system or the economy, the Federal Reserve must recommend heightened prudential standards to the primary financial regulatory agencies to apply to such identified activities and practices. Both the Treasury proposal from last summer and the financial reform proposal released by Senator Dodd last fall (the “Dodd Proposal”)<sup>3</sup> include essentially identical provisions, except that in the case of the Dodd Proposal, the systemic risk regulator could recommend the standards.

In each of these cases, the House Bill would give regulators the discretion to exercise their authority and contemplates individualized determinations and limitations by firm or activity, rather than wholesale restrictions. The exercise of this authority would give regulators the power to impose a mini-Glass-Steagall or a mini-Volcker Rule or any other restriction on any individual firm or across the U.S. financial sector.

In contrast, the Volcker Rule would require an across-the-board separation of commercial banking from proprietary trading and investments in private equity and hedge funds by all U.S. financial institutions. The Volcker Rule also would, as noted in Chairman Frank’s written statement about the rule, deliberately limit future regulatory discretion more intensely than would the House Bill.

## **Size Limits**

### ***Administration’s Proposal***

Very little is known about the Administration’s proposed size limits, which are aimed at limiting further consolidation in the financial sector and the growth of large financial institutions. The proposal imposes a limit on the growth in the market share of liabilities, including non-deposit funding, held by a large financial institution. This limit would supplement the existing prohibition on bank acquisitions or mergers if the acquiring bank would control more than 10% of the total deposits of insured depository institutions in the United States or 30% of those in any state, or as the state may require.

The Administration has argued that restricting size solely on the basis of insured deposits is outdated because it does not reflect the other, non-depository sources of funding relied upon by the largest financial institutions. Furthermore, the Administration has argued that the insured deposit concentration limit, standing on its own, carries a built-in incentive for firms to seek riskier, less stable sources of funding.

### ***Relationship to Pending Legislative Proposals***

While the House Bill contains provisions that could limit the size and consolidation of large financial institutions, it contains nothing as extensive as the size limits in the Obama Proposal. The House Bill extends the nationwide deposit cap on interstate mergers to transactions involving all insured depository institutions, not just banks. It also requires banking regulators to take into account the risks to the stability of the U.S. financial system when approving acquisitions and mergers by insured depository institutions, and requires prior Federal Reserve approval of acquisitions by a financial holding company of any nonbank company if the acquired assets exceed \$25 billion. The Dodd Proposal imposes these same requirements and also generally requires that systemically important financial companies receive regulatory approval for proposed acquisitions of nonbank companies with total consolidated assets greater than \$10 billion.

### **Impact on U.S. Competitiveness and International Proposals**

It is often forgotten in the U.S. domestic debate that Glass-Steagall type restrictions did not exist in other major European money centers and that one of the major reasons for repealing Section 20 of the Glass-Steagall Act, and especially its restrictions on equity underwriting, was to permit U.S. financial institutions to compete on a level playing field with their European peers. During the later years of the Glass-Steagall era, there was an elaborate regulatory structure created that limited the activities of foreign financial institutions in the United States and permitted U.S. financial institutions somewhat greater scope overseas. While Administration officials have stated that U.S. subsidiaries of foreign financial institutions would be subject to the proposal's restrictions, in today's globalized markets it is not likely that merely placing restrictions on the activities of foreign financial institutions in the United States would level the competitive field, particularly as competition derives not only from the European Union but from Asia as well.

### ***Mervyn King's Proposal***

As many have noted, the Volcker Rule could potentially create substantial competitive disparities between U.S. firms and their foreign counterparts if it is implemented in the United States but not elsewhere. According to media reports, some Administration officials are asserting that regulators around the world are considering similar proposals and, like the proposed TARP tax<sup>4</sup> on financial institutions, the Administration will apparently be using the G-20 and Financial Stability Board meetings to push these proposals elsewhere. It is also asserted that the Volcker Rule is less onerous than the banking proposal<sup>5</sup> put forth by Mervyn King, the Governor of the Bank of England, but his proposal has not been officially made by any government or regulatory agency.

## *The FSA's Position*

The FSA has been developing its policy stance on regulatory reform, which currently does not include a proposal to separate commercial and investment banking, or to impose “narrow banking,” although there is much discussion of this point in the U.K. press and among commentators.

As set forth in its October 2009 Turner Review Conference Discussion Paper<sup>6</sup>, and as reiterated by FSA Chairman Adair Turner in his speech<sup>7</sup> at the Turner Review Conference on November 2, 2009, the FSA's policy stance can be summarized as follows:

- the application of a capital (and perhaps liquidity) surcharge to systemically important banks;
- a greater emphasis on stand-alone national subsidiaries that a banking group's home country authorities would not be responsible for rescuing or resolving;
- a reduction of “interconnectedness” in wholesale trading markets through moving OTC derivatives trading to central counterparties and more effective collateral and margin call arrangements for bilateral trades;
- a significant increase in capital requirements applicable to a banking group's trading book, with a stronger differentiation between basic market-making to support customers and riskier trading activities, with a “bias to conservatism” for the latter; and
- a requirement for systemically important banks to produce recovery and resolution plans for their operations, which would be reviewed by their respective supervisors to determine whether any steps, such as internal restructurings, would be required to remove any serious obstacles to a plan's implementation.

The FSA justifies its approach because of the practical difficulties of drawing a distinction between allowed and prohibited activities. It is possible that narrow banking may return to the FSA agenda in light of the Obama Proposal and the upcoming elections in the United Kingdom.

The FSA and Her Majesty's Treasury have published proposals for recovery and resolution plans, and the FSA is expected to conduct a pilot exercise of resolution and recovery plans with major U.K. banking groups, to be completed by mid-2010. The Financial Services Bill, currently under consideration by Parliament, aims to impose a statutory duty on the FSA to require investment firms to produce these plans. Such plans could include, on an individualized basis, requirements to divest or limit activities under certain scenarios.

For a comparison of the Obama Proposal, the House Bill, the FSA's position and current regulatory authority, please see Annex A.

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**Annex A  
Comparison of Key Proposals and Current Regulatory Authority to Impose Size and Activities Limits on Financial Institutions**

	<b>Obama Proposal</b>	<b>House Bill</b>	<b>Current Regulatory Authority</b>	<b>FSA Position</b>
<b><i>Activities Limits</i></b>	<input type="checkbox"/> Prohibits insured depository institutions or depository institution holding companies from owning, investing in or sponsoring a hedge fund, a private equity fund or proprietary trading operations for their own profit, unrelated to serving customers	<input type="checkbox"/> Permits break-up of a super-systemically important firm upon a determination that its scope or size poses a “grave threat” to the economy <input type="checkbox"/> Permits prohibition on proprietary trading by a systemically important firm upon a determination of an “existing or foreseeable threat” to the company or economy <input type="checkbox"/> Permits regulation of systemically-risky activities by all regulated firms upon a determination of a threat to stability of the financial system or economy	<input type="checkbox"/> Limits activities of financial holding companies to those that are “financial in nature” or incidental or complementary thereto <input type="checkbox"/> Break-up authority over a bank holding company if activities or subsidiaries pose serious risk to the subsidiary bank, and cease-and-desist authority to terminate activities, rescind contracts and dispose of assets	<input type="checkbox"/> None; focuses on resolution and recovery strategies <input type="checkbox"/> Seeks to limit proprietary trading by imposing higher capital requirements (see below)



<p><b><i>Concentration Limits and Size Restrictions</i></b></p>	<p><input type="checkbox"/> Limits on the growth in market share of liabilities at the largest financial firms, to supplement existing limits on deposit concentrations</p>	<p><input type="checkbox"/> Requires banking regulator to take into account the risks to the stability of the financial system when approving acquisitions/mergers  <input type="checkbox"/> Requires prior Federal Reserve approval for acquisitions by financial holding companies of large nonbank companies</p>	<p><input type="checkbox"/> Imposes limits on bank mergers and acquisitions where the resulting institution would control more than 10% of the total insured deposits of insured depository institutions in the U.S. or 30% in any state, or such percentage as a state may require</p>	<p><input type="checkbox"/> None</p>
<p><b><i>Capital Requirements</i></b></p>	<p><input type="checkbox"/> None</p>	<p><input type="checkbox"/> Imposes heightened capital requirements on systemically important firms and financial holding companies</p>	<p><input type="checkbox"/> Imposes minimum bank capital requirements by statute; heightened capital requirements permitted under prompt corrective action regime</p>	<p><input type="checkbox"/> Imposes higher capital levels on assets held in trading books and for re-securitization deals</p>

<sup>1</sup> President Obama Calls for New Restrictions on Size and Scope of Financial Institutions to Rein in Excesses and Protect Taxpayers: <http://www.whitehouse.gov/the-press-office/president-obama-calls-new-restrictions-size-and-scope-financial-institutions-rein-e>

<sup>2</sup> Wall Street Reform and Consumer Protection Act of 2009: [http://financialservices.house.gov/Key\\_Issues/Financial\\_Regulatory\\_Reform/FinancialRegulatoryReform/hr4173eh.pdf](http://financialservices.house.gov/Key_Issues/Financial_Regulatory_Reform/FinancialRegulatoryReform/hr4173eh.pdf)

<sup>3</sup> Dodd Proposal: [http://banking.senate.gov/public/\\_files/AYO09D44\\_xml.pdf](http://banking.senate.gov/public/_files/AYO09D44_xml.pdf)

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<sup>4</sup> TARP Tax on Financial Institutions: <http://www.whitehouse.gov/the-press-office/president-obama-proposes-financial-crisis-responsibility-fee-recoup-every-last-penn>

<sup>5</sup> Bank of England: <http://www.bankofengland.co.uk/publications/speeches/2009/speech406.pdf>

<sup>6</sup> Turner Review Conference Discussion Paper:  
[http://www.fsa.gov.uk/pubs/discussion/dp09\\_04.pdf](http://www.fsa.gov.uk/pubs/discussion/dp09_04.pdf)

<sup>7</sup> FSA Chairman Adair Turner:  
[http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/1102\\_at.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/1102_at.shtml)