Transcript of video interview - US proposals for financial reform with Adrian Blundell-Wignall, Special Advisor to the OECD Secretary-General

I'm Adrian Blundel-Wignall, special advisor to the OECD Secretary-General. I wanted to talk a little but about the banking reforms proposed by President Obama the other day in terms of capping the size of institutions and limiting trading of institutions and exposure to hedge funds and the like.

Overall the OECD proposed something along these lines to the London Summit last year and we would welcome these kind of changes because the whole point of this crisis, the hallmarks of this crisis, were contagion risk and counterparty risk. That contagion risk really came through instruments such as derivatives and the like to which banks were exposed in various ways and in particular when they were risking their own capital.

When you think about what the capital of a bank is for, it's when people are pricing trades that capital will be there when it's needed. Now the problem with betting your principal is that you tend to do quite well in the good years but when a crisis happens, volatility spikes and liquidity dries up. It's precisely then that a lot of banks start losing their capital on their proprietary positioning and then of course there's less capital available than what the market had thought in dealing with the problems.

I think the proposal to take out hedge funds, private equity and the like, and also limit any part of proprietary positioning which is not in the interest of clients is a fairly good proposal because it will take down the exposure to these kind of mark to market instruments. Now hedge funds and private equities are quite clear: when you're getting government guarantees and lender of last resort and banks take the benefit of it, it's a subsidy to your cost of capital. Then of course you shouldn't really be setting up your own hedge funds and competing with hedge funds outside of banks with that subsidy in place so it's quite clear even for competitive level playing field reasons that that shouldn't really be a part of banking.

Let me say though that when it comes to things like special purpose vehicles, which are essentially a hedge fund structure that can be on or off the balance sheet of a bank, if you're going to exclude private equity and hedge funds then it seems logical that you need to start thinking about all these special purpose entities whether or not it's on or off a bank's balance sheet.

The other thing to think about on the proprietary trading side is that depending on how you define this proprietary trading is really going to define how draconian these measures are or are not. Because at the end of the day what is in the customer's interests, that's what we don't have a clear picture on: if you think about what's in the customer's interest, any time a bank trades a position with a client of any form to make a profit for its own profit, how can that be in the client's interest?

There are things like underwriting, market making prices and so on which are not trading against the client but any prop trading of your own capital, hopefully to make a profit, means someone is going to make a loss. If you think of it in those terms, what prop trading means, it could actually be quite general and therefore it would be taking out a key cog in the mechanism of all this structured product businesses, all the prop trading desks and the like which are very heavy in their use of derivatives. Those derivatives and their exposure to those derivatives is what caused the contagion risk between investment banking trading parts of the business and the commercial banking which also meant they were heavily exposed when institutions like AIG and Lehman Bros failed to counterparty risk. So by basically looking to limit those activities and do things which are just market making and underwriting and the like which are for clients but excluding all else it would take down the exposure to those instruments and that would seem to us to be quite a sensible step forward.

Does this mean that banks can’t do those things? No, it doesn’t. One way to think about these things is that banks would be forced to sell off those proposed groups like hedge funds, private equity and proprietary trading position-taking parts of the bank but you don’t have to do that. And the OECD proposal is a smoother way to do it which is essentially to have firewalls between the capital used by those different groups. Very clear strong firewalls so you don’t have to break up the bank. Those activities still happen, we just firewall the capital and make sure that when people are raising capital to do those prop trading positions, they pay the true cost of capital and markets are very clear about how much capital will be available in the event of problems. It would not be allowed to spill over in terms of contagion and other forms of risk into the commercial banking part of this model.

Now the second aspect of this: limiting size of the banks. Remember the US already had this in place in terms of deposits that any one bank shouldn’t be able to own more than 10% of the deposits and the proposal is to apply this to the general balance sheet of assets and liabilities so that you can’t get around this by raising other forms of deposits. This too is quite a sensible move because it stops banks putting these hedge funds and special purpose vehicles into the mix that would push them up to a very large size and the whole too big to fail issue is there.

Secondly, to the extent that it pushes funding into the shadow banking system. This may not necessarily be a problem. It just means that more shadow financial firms will start up to do these higher risk trades but they will not be deemed cross-subsidised by a bank and therefore their ability to grow in size will be less. They will be paying the true cost of capital, not the cross-subsidised cost of capital. And it’s appropriate that these activities happen outside the banking system. Now should those institutions start doing commercial banking activities so that we try to bypass the whole regulatory net then of course the regulators would have to make sure exactly what commercial banking means and have to bring those institutions back inside the regulatory net. Those are our two main conclusions. Thank you.