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## We Don't Need a New Version of the Glass-Steagall Act



The debate on the causes of the financial crisis includes the undisputable fact that, had the Glass-Steagall Act not been abolished, some of the excesses of the financial institutions would not have been possible. Having experienced both the European and the US banking models, I tend to believe that the Glass-Steagall approach, an institutional way to address the question, overlooks the importance of a market response.

The argument to protect the balance sheet of the large systemic banks by limiting their ability to conduct capital market transactions seems obvious; however, it disregards a vital fact. Should "commercial" banks not be allowed to operate in capital markets, we would have to find a way to finance growth outside of the banking sector. This means more securitization, more offloading of assets from banks, in other words more systemic risks for capital markets.

The argument to protect the

The regulatory approach undertaken so far has taken an institutional route, which will not provide a sustainable solution. The regulatory approach has to include a matrix. Institutional regulation, or better the fiduciary approach, is the horizontal part. It is perfectly consistent with the White House proposal to increase the power and scope of the Federal Reserve regulatory oversight. But that approach alone will not create a true level playing field for the various types of risks and activities. Furthermore, it will create huge institutional discrepancies and distortions and a series of unintended consequences.

The vertical side of the matrix is a combination of assets and markets. The purpose is to define a risk profile of assets, taking into consideration the capital market in which they are traded. This is not theoretical at all. Let me cite several relevant examples.

Actively traded fixed income or equity positions on the books of any financial institution have to be matched by adequate capitalization. There should be no regulatory arbitrage to allow such positions to be treated differently whether they are owned by a commercial bank, an investment bank or a hedge fund. In other words, those positions should require the same level of capital. That would abolish the 2004 lifting of equity ratios on investment banks, not by changing their equity ratio, but by weighing the same assets the same way.

Derivatives, and especially credit derivatives, must be weighted in a way that reflects the nature of the risks from which they derive. It makes no sense to weigh in an equity or bond derivative the same way one weighs a currency option or future.

Structured products would require particular attention, especially when it comes to complex unlisted underlying assets. Standardization of structured products will be essential. The size and development of the most sophisticated structured products might need to be scaled down. This is where specialized agencies could make sense, based on specific verticals.

The matrix approach does not in itself define the need for equity and capital of financial institutions. One other step is needed: the equity ratio of an individual financial institution will need to be based on the blended asset and risks of its individual balance sheet.

Needless to say, those ratios have to be incorporated into the Bank of International Settlements ratios across the world to avoid geographic regulatory arbitrage.

This approach is not new, but thus far has been limited to banks: it is the principle of using the same ratios independently of the nature of the financial institution that changes everything. You can expect hedge funds, managers and distributors of those instruments to fiercely resist an approach that forces them to apply the same risk ratios as banks.

They will claim that this restricts the development of financial innovation or securitization. They used that argument before. The reality is that it puts financial markets and institutions in front of their responsibilities. All we are saying here is that only those who are adequately capitalized can play in that league.

The other way to look at it is that every financial institution will be able to choose their risk profile independently of their nature. They will also allocate and raise equity accordingly.

If that is the case, there is no reason for a new Glass Steagall Act. Institutions will embrace different models according to what they expect to deliver to their shareholders, and will have to disclose the nature and size of their risks. It is likely to force some restructurings, but with a level playing field that does not exist today. It would actually be good.