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By Electronic Submission (www.regulations.gov)

Members of the Financial Stability Oversight Council
In care of the Secretary of the Treasury, Chairman of the FSOC
1500 Pennsylvania Ave, NW
Washington, DC 20220

Re: Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds; Docket Number: FSOC-2010-0002; Billing Code: 4810-25-P; Question #12 (and Questions #2, #3, #4, and #10)

Dear Members of the Financial Stability Oversight Council:

Thank you for the opportunity to submit these comments on the study regarding implementation of Section 619 of the Dodd-Frank Act, also known as the Merkley-Levin provisions on proprietary trading and conflicts of interest or as the Volcker Rule.

Summary
I would like to offer three main comments:

1. Mismanagement of risks that involved effectively betting the banks' own capital was central to the financial crisis of 2008; this is why our largest banks failed or almost failed. The Merkley-Levin Volcker Rule, properly defined, would significantly reduce systemic financial risks looking forward. Congressman Bachus's comment to contrary (as submitted to the FSOC, as part of the Public Input for this Study, dated November 3, 2010) is completely at odds with the facts.
2. Trades need to be scrutinized in a detailed and high frequency fashion. It is not enough to rely on relatively infrequent and "high level" inspections – or the established supervisory process. The comments provided to you in this regard by Senator Harkin (dated October 20, 2010) – and also by Senators Merkley and Levin (dated November 4, 2010) – are exactly on target.
3. The separation between banks and the funds they sponsor, in any fashion, needs to be complete. The argument offered by State Street and other "Custodian Banks" in their comment to you (dated October 27, 2010) is worrying and potentially dangerous, because it ignores the basic economics that leads to bank failure.

The remainder of this letter expands on these points.

The Importance of the Volcker Rule

With regard to the importance of the Volcker Rule (e.g., for your Question #12), James Kwak and I provided a great deal of supportive evidence in our book, *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown* (see http://13Bankers.com). American prosperity does not rest on having global megabanks of this nature and scale; we definitely do not need them to have proprietary trading businesses. They pose great dangers to our financial system – and to taxpayers, as seen in the aftermath of the 2008 financial crisis. Please be sure to take our analysis into account when considering this matter.
The Volcker Rule is not a panacea but if designed and implemented appropriately, it would constitute a major step in the right direction. The effectiveness of our financial regulatory system declined steadily over the past 30 years; it is time to start the long process of rebuilding it.[1]

With regard to your Question #6, on capital requirements, which is closely related to these general questions, I urge you to read the latest writings from leading analysts of this issue.[2]

In particular, I would stress that Professor Anat Admati and her colleagues find that stronger capital requirements would not be contractionary for the economy (see footnote 2). Professor Jeremy Stein and his colleagues show that capital requirements can and should be increased through requiring specific dollar amounts of capital to be raised – rather than through requiring banks to hit a particular capital-asset ratio (see footnote 2). If you proceed in the fashion that they recommend, stronger capital requirements will make the financial system safer – without any discernible effect on short-run growth and making it more likely that we can sustain reasonable growth rates over the next 10 years.

Related, and with regard to your question #10, Congressman Bachus argues at length that our international trading partners will not adopt any measures parallel to the Volcker Rule and therefore we should shy away from implementing the Rule. This is a non sequitor.

Our biggest banks have become dangerous by any reasonable standard – the supporting evidence is the deepest recession since 1945, more than 8 million jobs lost, and a 40 percentage point increase in the ratio of

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[1] Not surprisingly, there is a great deal of agreement among leading academics, financiers, and other business people on the need to rein in – as much as possible – reckless risk-taking by very large banks. As an example, see the endorsements provided by a broad cross-section of prominent figures for the arguments in *13 Bankers*: http://13bankers.com/reactions/#endorsements.

[2] These are available through links in the following articles: "Why Higher Capital Standards Are Needed," http://economix.blogs.nytimes.com/2010/07/29/why-higher-capital-standards-are-needed/ and "Goldman Sachs and The Economy," http://economix.blogs.nytimes.com/2010/10/07/goldman-sachs-and-the-economy/.

privately held federal government debt-to-GDP.[3] If other countries fail to follow our lead, that is worrying – mostly because they will be setting themselves up for further trouble.

Please look at my assessment of financial sector policy and fiscal impact in Europe (joint with Peter Boone).[4] Europe faces serious difficulties because of failures to control the behavior of major banks. We should in no way be inspired to follow their lead. The US needs to deal with its own problems first – and then encourage other countries to do likewise.[5]

If dangerous and irresponsible activities – financial or otherwise – leave the United States for elsewhere, we should in no way encourage them to stay here. Instead we should focus on warning others about why they (and the global economy) will not benefit from harboring and tolerating such behavior.

Congressman Bachus argues that implementing the Volcker Rule will hurt the shareholders of major banks. This is far from clear – shareholders lost heavily when banks' gambles went so dramatically wrong in 2007-08. But even if it were the case, this would be irrelevant. The goal of your rule making is surely not to help a particular set of shareholders, but rather to strengthen financial stability and increase the likelihood that we will not fact another devastating financial crisis.
You should definitely and deliberately avoid actions that elevate the interests of bank shareholders above broader social concerns. The goal here is precisely to step back from the "too big to fail" implicit subsidy arrangements that have developed around our biggest banks in recent years.

Degree of Required Scrutiny

Relevant to your Question #2, I strongly support the views of Senator Harkin, as expressed in his comment to you on October 20, 2010, as well as the positions of Senators Merkley and Levin, in their comment to you on November 3, 2010. I testified in favor of the Volcker Rule in February to the Senate Banking Committee and respectfully suggest that you take my testimony into account when considering this matter.[6]

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[3] On the broader economic and fiscal impact of the financial crisis – and why we should fear a repeat of something similar in the near future, please take into consideration the points made in my testimony to the Senate Budget Committee twice in 2010: August, http://baselinescenario.files.wordpress.com/2010/08/testimony-to-senate-budget-committee-august-2-2010-final.pdf; and February, http://baselinescenario.com/2010/02/09/revised-baseline-scenario-february-9-2010/.2010-final.pdf; and February, http://baselinescenario.com/2010/02/09/revised-baseline-scenario-february-9-2010/.

[4] Available on-line as part of London School of Economics volume on *The Future of Finance*; our chapter is "Will the Politics of Global Moral Hazard Sink Us Again?" http://www.scribd.com/doc/34583368/The-Future-of-Finance-The-LSE-Report (pp. 247-288).

[5] The fact that our biggest banks want to become even larger and even more global should worry us a great deal – particularly as there is no cross-border resolution mechanism for banks on the horizon. Please see the details and analysis in "Way Too Big To Fail," http://www.tnr.com/article/economy/magazine/78563/way-too-big-fail.

[6] My testimony is available here: http://baselinescenario.files.wordpress.com/2010/02/testimony-submitted-to-the-senate-banking-committee-feb-3-2010-sj-final2.pdf.

On the same panel in February, representatives of Goldman Sachs Group Inc. and JPMorgan Chase & Co. pushed back strongly against the Volcker Rule. Given the adamancy with which those banks argued so recently against the Volcker Rule, it is not unreasonable to wonder about their intentions now.

If a bank's management wants to take proprietary risks using its own capital, these would be relatively easy to disguise on a trading desk as "customer flow" in some way. Some big banks have already announced that proprietary trading jobs will be cut, including at JPMorgan after the firm reportedly lost $250 million on coal trades in the second quarter (although perhaps these developments are not connected). Bank of America Corp. has announced that proprietary traders will be switched to other jobs within the firm.[7]

But as Michael Lewis asked recently: how would anyone know whether proprietary trading reappears in disguise? Lewis also pointed out that, at least in the case of Goldman Sachs, some of the most important transactions with regard to committing or protecting the firm's own capital in the recent past were undertaken by their so-called Client Facing Group (see footnote 6). This doesn't imply there was any deception, simply that risks can be placed in any number of locations within such an organization.

We know that big banks like to bet big, particularly as the credit cycle develops. Sometimes this goes well for them and their shareholders, and other times it goes badly as it did for Goldman Sachs when it reported losses on equity derivatives in the second quarter. When large bets go bad the damage can be so catastrophic that the entire credit system is disrupted and the tax payer is again on the hook. Again, please consider my work with Peter Boone for your deliberation on this matter (cited in footnote 3 above.)

There is no way to handle the failure of global megabanks because there is no cross-border resolution mechanism or bankruptcy procedure that can handle their failure, a point I made with co-author James Kwak in *13 Bankers*. The idea that too big to fail has been legislated away is simply an illusion.

There is nothing anti-business about wanting to enforce the Volcker Rule. Quite to the contrary, the severity of the financial collapse in the fall of 2008 was very much about how big banks acquired and mismanaged huge risks -- not all of which were within officially designated prop-trading groups -- and in the process damaged the rest of the financial industry and the broader economy.

The Volcker Rule may not be perfect but at this stage it's almost all we've got. And with regard to voluntary compliance by the big banks, we should reflect on Ronald Reagan's thinking with regard to nuclear disarmament commitments by the Soviet Union, "trust, but verify."

[7] For links to articles documenting these developments, please see "Proprietary Traders 'Earn Trust, But Verify'", http://www.bloomberg.com/news/2010-10-08/proprietary-traders-earned-trust-but-verify-simon-johnson.html.

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Relationship Between Banks And Investment Funds

Relevant to your Questions #3 and #4, you received on October 27, 2010, a comment from State Street (on behalf of itself, Northern Trust and BNY Mellon), which I would strongly oppose.[8]

The State Street argument is that section 619 of Dodd-Frank could prevent a bank "from providing traditional directed trustee or similar services to its pension fund and other institutional clients."

The issue, State Street points out, is "potential banks' support for the investment performance of the fund" – that is, whether a bank would feel obliged to prop up the performance of a fund that is struggling. The problem with such propping up is that it will help a fund show better performance on average – and therefore help it attract more money – but it would also mean a bigger collapse, with much more devastating consequences, should subsequent problems arise (which is not so uncommon). Propping up is a fairly common phenomenon around the world.[9]

State Street and its co-signers argue that banks such as themselves frequently do not have investment authority over plans for which they are trustees. But this is not the issue.

The real question is whether a custodial bank of any kind would have the incentive to prop up performance of a fund (of any kind). This is the way that banks can find themselves committing capital, whether they originally intended to or not. The sounder relationship between bank and fund is that when bad things happen, the bank is content to let the fund fail (or just show disappointing performance).

State Street and the other big banks mostly just want to be left alone. "We're responsible adults and we can take care of ourselves" is their refrain. This was exactly the operating philosophy of Alan Greenspan, circa 1997: "As we move into a new century, the market-stabilizing private regulatory forces should gradually displace many cumbersome, increasingly ineffective government structures" (as quoted in *13 Bankers*, p.101).

The new century has not, so far, gone well, precisely because "market-stabilizing private regulatory forces" turns out to be an oxymoron.

And the specifics at stake here are far from hypothetical. Remember that Citigroup had large "off-balance sheet" housing-related liabilities that it ended up bringing back onto the balance sheet – thus absorbing the

[8] As posted at
http://www.regulations.gov/search/Regs/home.html#documentDetail?R=0900006480b787ad.
[9] For more background and an analytical framework on these issues, please see "Propping and Tunneling," published in the *Journal of Comparative Economics* in September 2003 and available at http://baselinescenario.files.wordpress.com/2010/11/propping-and-tunnelling-feb-11-2003.pdf.

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losses and forcing itself closer to insolvency.[10] And even State Street had to prop up some of their "stable value funds".[11]

Please do not repeat Mr. Greenspan's tragic and costly mistake. We need a real firewall between custodian banks and the funds with which they are connected in any form. The Volcker Rule, if properly and rigorously applied, can do just that.

Yours sincerely,

Simon Johnson

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[10] For relevant details see http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a6dgIOAfMIrI and http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aT0Ix2iDnZRk.

[11] See http://blog.trade-radar.com/2009/01/state-street-props-up-stable-value.html.