Proposals to Regulate Proprietary Trading

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November 18, 2009

The relaxation of restrictions on borrowing by banks under the Financial Services Modernization Act (Gramm-Leach-Bliley) of 1999 that facilitated the increase in lending by financial institutions to other financial institutions and the Securities and Exchange Commission’s (SEC’s) relaxation of leverage ratios for investment banks in 2004, led to the explosion in proprietary lending that inflated the balance sheets of large financial institutions. Proprietary trading occurs when commercial banks, investment banks and hedge funds use borrowed funds to make investments for their own accounts rather than the accounts of customers. Regulatory proposals to rein in proprietary trading include both those that would impose an outright ban on the activity by banks, as suggested by former Federal Reserve Board Chairman, Paul Volcker, and those that would do so by restricting leverage and/or limiting financial institutions’ short-term borrowing (see Jane D’Arista Congressional Testimony). The latter include:

- Higher capital requirements on assets banks acquire through proprietary trading.
- Liquidity requirements to limit short-term borrowing by banks.
- Re-imposing pre-2004 leverage ratios on investment banks. The SEC’s 2004 relaxation of leverage limit for investment banks resulted in a change from $12 to $30 per $1 dollar of capital.
- Leveling the playing field by imposing leverage limits on all financial institutions, including the finance arms of conglomerates and hedge and private equity funds. These limits could be raised or lowered by the systemic regulator to counter either a boom or downturn.
- Margin requirements on all tradable instruments, not just equities. These requirements would constrain excessive use of leverage by nonfinancial as well as financial speculators and give the systemic regulator another countercyclical tool to dampen or encourage trading in particular assets such as mortgage-backed and other asset-backed securities as well as commodities and derivatives.
- Extending the provisions of the National Bank Act to limit individual and aggregate bank lending to financial counterparties in relation to capital.
- Imposing a tax on securities transactions to provide a disincentive for trading.

These regulatory proposals provide a framework that favors rules over discretion by adding quantitative rules that can moderate the growth of financial institutions and control excessive credit expansion.

References