

[A "Thank You" to President Obama from the European Banking Industry](#)

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Summary

Matthew Lynn's ("ML's") article on Bloomberg today ("[Wall Strasse Beats Wall Street on Obama Bank Bill](#)") offers a vision of global leadership by Europe's banks thanks to President Obama's proposals to restructure US banks. I agree with ML that the proposals do more to punish banks (read: "Goldman Sachs") for excess remuneration, than provide a logical response to systemic financial risk. Yesterday's article on FT alphaville ("The background to the Volcker Rule") provides useful context to ML's piece.

Analysis

I posted an analysis yesterday ("Obama's bank reforms: the Ryder Cup of banking?"), questioning the rationale behind the choice of activities that banks should, in future, be barred from offering. It appeared too much of a coincidence that the President should twice-in-one-week describe bank bonuses as "obscene", and then shortly after announce plans to force banks to offload the units giving rise to much of 2009's excess bonus pool. In between he lost a Senate seat, held by the Democrats for the last 50 years.

As Tracy Alloway highlighted in her alphaville piece, it is fascinating to see "senior administration officials" contort themselves to avoid using the words "Goldman Sachs", but the Treasury briefing confirmed what many of us suspected, namely that Obama's proposals are more about punishing Goldman Sachs for causing him embarrassment and political problems, than they are a logical blueprint for engineering systemic risk out of the financial services industry. Of course, this then begs the question: are Obama's proposals really an attempt at changing the structure of US banking, or are they merely an attempt to encourage changes to remuneration practices on Wall Street? As I noted in yesterday's piece, the UK approach to the (political) problem of excessive remuneration has not worked. An apparently draconian levy of 50% of most bonuses, the levy itself not allowable against taxable profits, has singularly failed to rein in the payments. There have been some token deferrals at senior level, but the aggregate amount of bonuses being paid in London looks like being over four times higher than the UK Treasury estimated when the levy was announced. Implicitly, that approach appears to have failed. Is Obama just trying a different one, with much greater long-term implications for the organisations affected than the UK's one-off levy?

That brings us to ML's commentary. His premise is pretty much the same as mine: Obama is punishing Goldman Sachs and its ilk. He then, however, essentially poses a "what if" scenario. "What if" the proposals are implemented? How will the US banks respond? And his view is that they will simply restructure so as to avoid the restrictions. This seems a reasonable assumption to me, and one for which there is historical precedent. Glass-Steagall was, to some extent, undermined by US banks doing precisely this from the 1970s onwards, and certainly from the late-1980s when financial services and markets were deregulated in the UK. Then they simply established trading and other activities in London which they could not do in the US.

ML is absolutely right that there is no reason from a risk perspective to ban banks from participating in private equity and hedge funds. It is difficult to see how involvement in private equity could conceivably cause systemic risk to the financial system. Perhaps it could bring down a particular institution, but that is not what Obama's proposals are trying to prevent.

The next question that arises is whether Europe will feel the need to mimic Obama's proposals. Indications from the UK Treasury are that they will not. The UK response to date has been as negative as it could be whilst maintaining a united front in the fight to remodel global finance. This may change as the Conservative Party appears supportive, and it is likely they will be in government within six months. The current government is doing plenty to discourage financial services firms from locating, indeed remaining if they are already there, in the UK. However, the kind of legislative bar on activities as proposed by Obama does not seem to be on the agenda. It is a formula that is alien to the UK, indeed Europe generally. As the UK's Finance Minister has pointed out, it was the connectivity within the financial system that caused the crisis, not the failure of any particular "too large to fail" institution.

What I am less sure of, however, is just where any "US refugees" should establish themselves. It is far too simplistic just to suggest putting everything in London or Frankfurt. Private equity and hedge funds, for instance, both fall within the draft EU Alternative Investment Fund Manager Directive ("AIFMD"). Concerns over the impact of that are partly at least behind the migration of hedge funds from London to Switzerland. In addition, the implication of moving from Wall Street is that banks' global business in the restricted activities would be centred in London or wherever. The UK, however, has been attempting to broaden its corporate tax net to include some income derived from outside the UK. That is behind many of the headquarters' relocations from the UK to jurisdictions such as Ireland over recent years.

Relocation will be a much more complex "jigsaw" than is perhaps apparent. Much of the operational infrastructure required for the activities covered by Obama's proposals exists only in London on the required scale. However, for regulatory purposes, it makes more sense to locate certain decision making in, say, Switzerland. Investment management of alternative asset classes is an obvious example. The greatest flexibility in terms of corporate tax and freedom to adjust group structures in the future points to Ireland as the optimum headquarter's location (low corporate tax, no transfer pricing, tax-free group restructuring, common law legal system, and English as a first language to note the main advantages). At the personal level, London is not welcoming to non-UK domiciled individuals. They are expected to submit to taxation of global income/gains in the UK or at least pay a fee to avoid it. The Swiss and the Irish are far more relaxed about having foreigners not paying tax on anything derived from outside their jurisdictions. The point to note is that the optimum solution may involve a combination of "doing" things in, say, London, but establishing decision making "substance" elsewhere, eg Geneva and/or Dublin.

I still think a significant watering down of Obama's proposals as they wind their way along the legislative path is the more likely solution. Relocation is an option for the banks, but it would be costly financially and divert management attention from the "day job". Lobbying the administration and Congress about the potential tax losses if banks do relocate ought to ensure significant amendment will emerge out of mutual self-interest. If this does not happen, then I think our American cousins will find a welcome in Europe, though do not assume that the existing financial centres are the only "go to" options. There are plenty of new kids on the block willing to make friends with incomers from across the Atlantic.