

Size really does matter to Paul Volcker

Comment
Glenn Mumford

It was timed to perfection. A fireside chat two months ago between two of the biggest critics of the "Big Bank" mania. Released just days before world leaders meet to debate regulatory reform at the Group of 20 summit in Pittsburgh.

We had retiring Minneapolis Federal Reserve president Gary Stern dishing up Dorothy Dixers for his old friend, former US Fed chairman, Paul Volcker.

They didn't disappoint. What we got was a clear call for the separation of core banking and trading functions and a rejection of the conglomerate business model.

Could we achieve a return to "traditional commercial banks" and could "other institutions" again take responsibility for proprietary trading and hedge fund activity? asked Stern.

"Well, I think we can," observed Volcker, before adding that we must first expect plenty of opposition from the banks. "It's just an obvious conflict of interest between the hedge fund, the trading and the private equity business in what they're doing advising their customers."

But surely this isn't a problem given the presence of Chinese walls, asked Stern. Yes, they have walls, noted Volcker. It's just that "I don't believe those walls are impermeable".



Former Fed chief Paul Volcker, left, wants Barack Obama to separate commercial and investment banking businesses. Photo: AP

Volcker originally launched his attack on the "too big to fail" mantra back in March. Separation helped "keep them small, so that any failure won't have systemic importance", he argued at the time.

He called for a return to the Glass-Steagall separation of banking powers that applied from the 1930s, until their repeal in the late 1990s. This put him at odds with Barack

Obama's National Economic Council chief, Larry Summers, who is a strong supporter of the status quo.

Volcker, chair of Obama's Economic Recovery Advisory Board, lost the initial argument and seemed to take a back seat on the question of bank size. Until now. To date, the Obama administration has preferred pushing for effective oversight of what they're now calling

"systemically significant financial institutions", rather than take any action to limit size. For his part, Fed chairman Ben Bernanke has accepted the need to have an appropriate safety net, given these "systemically significant financial institutions".

But in Europe there's been a growing push, particularly among central bankers, to consider restrictions on bank size — either

through formal separation of business lines or through the imposition of capital disincentives. Last week, the Bank of England's Andrew Haldane pointed out that "there is not a scrap of evidence of economies of scale or scope in banking". In fact, over the past year "big banks have, if anything, been found to be less stable than their smaller counterparts".

This would be music to Volcker's ears. His challenge now is circumventing Summers and persuading Obama of the need to legislate against large institutions with business models capable of subverting core consumer and business lending capabilities.

"I don't think we can live with a situation where an investment bank keeps a banking licence while doing things that are properly done by an investment bank," Volcker told Stern.

The timing of his commentary suggests he's keen to steer the G20 debate away from any narrow focus on "too big to fail" and back on to a debate over which banking functions should be supported by government. "There's nothing wrong with making money... but I don't want them to make money by taking risks with the support of the taxpayer," he added.

Wall Street will be hoping this remains a minority view when the G20 pulls up stumps at Pittsburgh.

Rear Window, page 44
Features, page 61

Cautious investors take some profit

Equities
Justin Bailey and Phillip Baker

The sharemarket ignored a positive lead from Wall Street and fell yesterday as investors ditched stocks that have led the recent rally, including the major banks and miners.

The S&P/ASX 200 dipped 15.8 points to 4677.4. The broader All Ordinaries lost 9.6 points to 4684.1.

Investors were betting on a pull-back yesterday, taking profits off the table, as they sold on concerns that shares were overvalued.

The major index is trading on a forward price-earnings ratio of 16.4, about 11 per cent above its 10-year average of 15 times earnings estimates for the next 12 months.

Argo Investments portfolio manager Chris Hall said it paid to be cautious at the moment because it was difficult to tell how quickly the economy would recover.

"The big question is how fast the economy is going to recover and it's still a big unknown as to how quickly companies will grow once the government stimulus runs out," he said.

Japan, Singapore, Malaysia, Indonesia, the Philippines and India were shut for holidays. Shares in Shanghai rose 4.3 points to 2967.01 but Hong Kong's Hang Seng closed down 150.6 points at 21,472.9.

In the US on Friday, the blue-chip Dow Jones Industrial Average rose 0.4 per cent, while the S&P 500 gained 0.3 per cent.

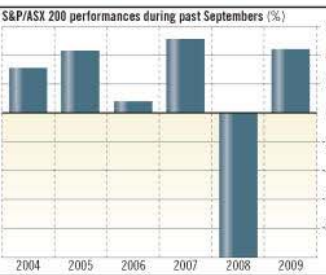
Despite yesterday's fall, the local sharemarket is still up 4.4 per cent this month and 25.6 per cent in 2009.

Qantas was unchanged at \$2.78 despite news that former chief executive Geoff Dixon was paid almost \$11 million for five months' work in the past financial year as part of his payment for leaving the company in November.

Chairman Leigh Clifford also said in the annual report that the

For the record

This month's best performers (%)	%
Medusa Mining	39.0
Macquarie Media	34.5
Lynas	32.3
Molopo	29.5
St Barbara	27.7
ING Industrial	27.5
SMS Management	27.0
PanAust	26.3
Al Lucas	23.8
Austar	23.1



airline had yet to see any signs of a rebound in the aviation industry, but added the company was well placed to take advantage of any economic rebound.

Building materials group Boral fell 1c to \$6.14 after it was announced that outgoing managing director Rod Pearse was paid \$11.5 million for the 2008-09 year, up from \$6.6 million in the previous year.

Mr Pearse announced his decision to retire in June after 10 years as chief executive and 15 years with the company.

Early losses on the market were kept to a minimum by news that sales of new motor vehicles picked up by 0.3 per cent, seasonally adjusted, in August, but sales were still down 6.2 per cent on a year earlier.

Mining stocks weighed on the market after commodity prices fell on the London Metal Exchange. BHP Billiton shed 6c to \$38.08, while smaller rival Rio Tinto dropped 31c to \$60.69. Among the mid-tier miners, Mirabela Nickel lost 11c to \$3.19 and Extract Resources shed 33c to \$10.27.

In the banks, Commonwealth

Bank of Australia was 19c lower at \$48.90, Westpac Banking Corp dropped 3c to \$24.88, National Australia Bank was down 32c to \$29.54 and Australia and New Zealand Banking Group shed 3c to \$23.15.

Macquarie Group fell 11c to \$54.34. Its Macquarie Airports satellite fund was up 4c to \$2.67, after it was revealed a consortium led by fund management veteran

The big question is how fast the economy is going to recover.

Chris Hall of Argo Investments

Mike Fitzpatrick had made a last-minute attempt to scupper Macquarie Group's controversial \$345 million deal to sever its long-term management contract with the specialist airports fund.

Oil prices showed signs of weakness, with traders expecting prices to fall below current levels by December. In late Asian trade, oil was changing hands at \$US71.50 a barrel.

H3 Global Advisors portfolio

manager Andrew Kaleel said barring any unforeseen weather conditions or geopolitical events, he expected oil to move back towards \$US60 to \$US65 a barrel.

But he didn't think we would see any "significant or aggressive" sell-off in the short to medium term and said oil below \$US60 a barrel represented good value.

Woodside Petroleum was up 58c to \$51.23, but Oil Search lost 1c to \$6.40 and Santos shed 26c to \$15.27.

Elsewhere, Gunns rose 6.5c to \$1.21 on speculation the group may enter a joint venture to buy the land, trees and forestry operations of Timbercorp under a proposal sent to the company's liquidators by Gunns yesterday in a regulatory filing.

Western Plains Resources was in a trading halt yesterday, pending the outcome of a proposed joint venture with a subsidiary of Wuhan Iron and Steel on the Hawks Nest Project.

Woolworths fell 4c to \$28.91. Ian Macfarlane, a director of the giant retailer and former head of the Reserve Bank of Australia, spent more than \$28,600 buying Woolworths shares, according to a notice filed on Monday.

Too much, too soon

From page 21

cycle which began in the August reporting season.

"The size and speed of the market rise has concerned some market analysts as it has been driven by valuation expansion and the earnings recovery appears to be a late 2009 to early 2010 story," Mr Sherwood said.

Although earnings per share were down by around 20 per cent in fiscal 2009, results came in largely better than expected and failed to disappoint investors, who were eager to buy shares at cheap prices.

The Australian sharemarket is trading on a forward price-earnings ratio of about 16 times, which is significantly higher than the depressed levels recorded in late 2008 and early 2009.

And analysts believe there are still opportunities for investors.

"The market looks fully valued to slightly stretched on one-year forward earnings," Mr Potter said. "Four or five months ago the whole market was cheap — now there's some things that aren't. Most of the market is becoming fairly well valued based on shorter term earnings."

While concerns are now growing about valuation fatigue, Mr Potter expects the sheer weight of money that investors are waiting to put back into markets could provide the foundation for a further market rise.

At the height of the downturn, investors pulled a record amount of money out of shares and parked it in cash. Now they are looking to invest that cash back into the sharemarket to take advantage of the strong gains.

"There's still a lot of cash to come in from the sidelines, but markets in Australia are very illiquid, so it's hard to get it back in," he said.

Traders fear correction, page 25