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Putting an End to Casino Banking:
Separating Capital Formation from High Risk Speculation

February 12, 2010

Dear Colleague:

Proprietary trading and investing was a key driver of the Wall Street behavior that led directly to the financial crisis. As you know, a bank engages in proprietary trading and investing when it uses its own capital to pursue above-market returns, like a hedge fund or private equity fund. Such trading and investing is highly risky because its profitability is directly correlated to the amount of leverage (debt) used and the risk (often the volatility or illiquidity) of the assets, be they stocks, commodities, properties, or derivatives. Because these bets were so profitable in good times, major investment and commercial banks in the run-up to the crisis effectively turned themselves into large, levered hedge funds and private equity funds. Sadly, that led directly to their collapse. Most of those remaining are now banks, protected by the taxpayer net.

We need to make sure that this type of taxpayer-backed gambling does not happen again. That is why I am preparing legislation to separate the protected capital formation services of banks and other systemically critical financial institutions from the high-risk gambling of hedge funds and private equity funds. My proposal builds upon those put forward by former Federal Reserve Chairman Paul Volcker and endorsed by President Obama in January. I will be proposing that we do the following:

- **Eliminate hedge fund and private equity gambling by banks.**
  - Covered entities should be prohibited from owning or operating hedge funds and private equity funds and from engaging in proprietary trading. This will dramatically reduce the incentive to accumulate high leverage and high risk.
  - Reasonable market-making, underwriting, and risk management activities should still be permitted, as long as they are not used as a backdoor means to place bets on volatile and illiquid assets.
- **Cover all institutions whose bad bets could threaten the system.**
  - Banks receive significant benefits from the taxpayer, like deposit insurance and access to the Fed's discount window, and all should be covered.
  - Nonbank financial institutions should also be covered if they make up a systemically material portion of wholesale funding markets or have systemically material counterparty exposures. That way, no systemically critical entity could escape the prohibition, and no entity engaged in high risk activities could grow to become systemically threatening.

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Of course, this separation is only one part of restoring the rules of the road on Wall Street. Much more needs to be done.

I look forward to working with my colleagues who share a commitment to ending the heads-I-win, tails-you-lose gambles at systemically critical financial institutions. While speculation and high-risk investing can be perfectly valid and economically useful, they cannot be permitted to occur again in our banks, where they jeopardize our nation's economy.

I hope you will join me in this effort. Please don't hesitate to contact me directly or have your staff contact my Banking Counsel, [redacted].

Sincerely,

Jeffrey A. Merkley

Jeff Merkley
U.S. Senator