Stiglitz: Obama bank proposals a big step forward

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NEW YORK (Reuters) - President Barack Obama's proposal to limit financial risk-taking at Wall Street banks is "a big step forward," Nobel laureate economist Joseph Stiglitz said on Thursday, but derivatives regulation is still needed.

"As is always the case with regulation, the devil is in the details, but this is a big step forward from where things have been," Stiglitz said in an interview with Reuters Insider TV.

Obama's proposals, which require Congressional approval, address the problem of banks that are "too big to fail" and take excessive risks, Stiglitz said.

The rules would set a cap on banks' size in relation to the overall financial sector and prevent financial firms that own banks from investing in, owning or sponsoring a hedge fund or private equity fund.

The rules would also bar some banks from making bets on financial markets with their own money that are unrelated to serving their customers.

The White House blames some of these practices for bringing the financial system to the brink of collapse in 2008.

Stiglitz, who teaches at Columbia University, said the lesson of the 2008 financial crisis is that "even investment banks need to be tightly regulated."

But he said the rules don't go far enough in regulating derivatives, which are based on underlying assets including bonds and commodities or can be tied to currency and interest rate moves.

Derivatives were blamed for exacerbating the credit crisis and contributed to a run on assets that helped topple banks, including Lehman Brothers.

Derivatives are a problem "not only with the very big banks but could lead to banks that are not only too big to fail but financial institutions that are too intertwined to fail, as is the case with the AIG episode last year," he said.

American International Group needed a massive government bailout after it took out-sized exposures to risky assets using credit default swaps, which are used to insure against a debt default.

Obama's proposals have drawn some comparisons to the Depression-era Glass-Steagall Act, repealed in 1999, that mandated division between banks with commercial activities and depositors and investment banks.

Stiglitz said reinstating the law as written is not needed, "but the basic concept -- trying to avoid conflict of interest, making sure the commercial bank does not undertake excessive risks -- that principle is important," he said.

(Reporting by Jen Rogers; Writing by Steven C. Johnson and Karen Brettell)