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The Case against the Volcker Rule

Misguided Response to Financial Crisis Hinders Small Businesses' Access to the Capital they Need to Expand and Hire

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The 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act has severely restricted business and consumer access to credit and capital. One of the key regulations contributing to this is the Volcker Rule, named after former Federal Reserve Chairman Paul Volcker. He originally proposed it believing that speculative activity on the part of banks played a significant role in the financial crisis of 2007-2008.

The Volcker Rule prohibits federally insured commercial banks from engaging in certain types of proprietary trading or investing in hedge funds or private equity funds. Proprietary trading is when a firm trades its own capital for profit. The rule exempted market-making (trading securities on a financial firm's own account to facilitate potential future trades), hedging (trading securities on a financial firm's own account to mitigate the firm's risks elsewhere), and trading in government securities from the proprietary trading prohibition.

While established under Dodd-Frank in 2010, the nearly 1,000-page regulation took five different financial regulatory agencies over three years to write. The rule was produced by the entire Financial Stability Oversight Council (FSOC), a multi-agency financial regulatory body created by Dodd-Frank. FSOC members include the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. The final rule was implemented in 2015.[1]

The Volcker Rule impacts everyone in the financial system, from banks and investors to small businesses and consumers. It threatens market liquidity by making it harder for banks to trade securities. When capital markets are less liquid and dynamic, small businesses, which are the lifeblood of the economy, struggle to access the capital they need to expand. Consumers who hold credit cards, mortgages, or car loans see their costs of obtaining credit rise. For local economies, this can be the difference between growth and stagnation. The Volcker Rule may have been aimed at Wall Street, but it has hit Main Street the hardest. Fortunately, Congress has an opportunity to provide some relief from this harmful rule, but more will be needed. The Volcker Rule should be repealed.

Why Was the Volcker Rule Implemented? The Volcker Rule was originally aimed at restricting the activities of the largest Wall Street banks, an attempt to make them more

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conservative and stable. This was based on a flawed analysis from the Dodd-Frank Act, which found that commercial banks' trading activities were a cause of the financial crisis. A look at the types of institutions that failed during the crisis clearly demonstrates the flaw. The investment banks that failed, such as Bear Stearns and Lehman Brothers, had no commercial banking arms. They could not use federally insured deposits to make speculative bets. The commercial banks that failed did so because of subprime mortgage lending, not proprietary trading.[2]

The crisis resulted not from risky trading, but from poor lending practices. This has been consistently reaffirmed by government reports. A 2011 Government Accountability Office report, for example, stated: "FDIC [Federal Deposit Insurance Corporation] staff, whose organization oversees bank failures, said they were not aware of any bank failures that had resulted from standalone proprietary trading."[3]

Should Proprietary Trading Be Strictly Regulated? All financial operations involve risk. Trading in securities for a firm's own account and affiliating with private equity and hedge funds is not inherently excessively risky. As Heritage Foundation analyst Norbert Michel notes: "Although it seems logical to stop banks from making risky bets with federally insured deposits, banks make risky investments with federally insured deposits every time they make a loan."[4]

Lending is itself a risk-laden bet with a bank's own capital—a long-term bet on a borrower. This can be riskier than trading, as we saw during the financial crisis. Further, because securities have many buyers while individual loans have few, the liquidity risk on commercial loans—the potential inability to turn the asset into cash—is typically worse than that in securities trading.[5]

If proprietary trading were so risky that some forms of it should be prohibited, then the rule should apply across all industries and asset classes. But it does not. Instead, it only prevents commercial banks from such trading. Congress effectively acknowledged the substantial benefits of proprietary trading when it continued to allow trading in federal, government agency, and state and municipal bonds. Dodd-Frank allows trading in as much junk municipal debt as possible, but not trading on investment-grade corporate debt. "Risky trading" is allowed only when it finances government debt.

How Has the Rule Been Implemented? The critical issue with implementing the Volcker Rule is that it is incredibly difficult to discern between what is legitimate market-making and hedging, and what is prohibited proprietary trading. Did a trader take a certain position to set up a future trade (market-making) or was that trader speculating on the change in price for the firm's own profit (proprietary trading)? It is not obvious to anyone but the traders themselves. As a result, the rule requires arbitrary decisions by regulators, who essentially have to guess the intent of the trader. Even the rule's architects have recognized this. The former Federal Reserve governor and point man for the regulation, Daniel Tarullo, acknowledged that the rule is too complex to enforce properly.[6]

Has the Volcker Rule Reduced Financial Risk? Despite its aim to reduce risk in the financial system, the Volcker Rule has done the opposite. The major issue is the impact on corporate bond liquidity.[7] Liquidity is essential to a well-functioning financial system. It can determine the cost of capital and influence financial stability.

The Volcker Rule has hurt the liquidity of corporate bonds. A recent Federal Reserve staff paper found that the Volcker Rule has had "a deleterious effect on corporate bond liquidity and dealers subject to the Rule become less willing to provide liquidity during stress times. … [W]e find the disturbing result that illiquidity in stress periods is now approaching levels see[n] during the financial crisis."[8] If trading is affected by second-guessing against vague regulations, then instead of being absorbed by market liquidity, problems in the financial sector can spread quickly to the broader economy.[9] But this is not the only issue.

Banks must take risks to remain profitable. Regulation prohibiting some types of risky activity will simply lead to an increase in other types of risky activity. In response to the Volcker Rule, some banks have merely shifted risk from their trading books to their commercial loan books.[10] But this does not reduce their overall risk taking. A 2016 study by Jussi Keppo of the National University of Singapore and Josef Korte of Goethe University Frankfurt found "evidence that the affected banks raised their trading risk and decreased the hedging of their banking business."[11]

While all financial activities involve risk, diversification of activities and revenue streams actually reduces risk and makes banks more stable.[12] Basic portfolio theory states that combining two risky activities makes them less risky in combination than each would be on its own.[13] The Volcker Rule, on the other hand, has forced out what regulators believe to be risky activity, impeding diversification and concentrating risk. A ban on these activities does not promote banking safety and soundness.

What Has Been the Impact of the Volcker Rule?

For Consumers and Business. The Volcker Rule hurts Main Street businesses and consumers, who are dependent on liquid and accessible debt and equity markets. By banning proprietary trading and inadvertently discouraging legitimate market-making and hedging, the Volcker Rule has pressed investors to seek higher liquidity premiums for bonds issued by smaller firms, which has made it harder and more expensive for businesses to raise capital. Artificially preventing businesses from raising capital means lower aggregate investment, production, and employment.

Main Street consumers are strongly reliant on well-functioning capital markets. Credit card debt, student loans, and mortgages are all packaged up into securities to be sold and traded in capital markets. Market-makers for these kinds of assets keep liquidity flowing through the system and hold down costs for consumers.

For Regional and Community Banks. Paul Volcker himself noted that he thought the rule would only impact the four or five largest banks.[14] Yet the rule has burdened thousands of

small- and medium-sized banks. By unnecessarily punishing smaller banks, the Volcker Rule has reduced lending that finances local economic development.[15]
While larger competitors can hire the best lawyers to devise ways to navigate around the rule, small banks cannot. As a result, they have had to reduce and even stop using derivatives for risk management due to uncertainty.[16] For example, Salt Lake City-based Zions Bancorporation was forced to divest a long-held debt security and take a loss of $387 million.[17] This cost Zions more than it had earned for any calendar year since 2007. Developed in direct response to the risk taking of Wall Street, the Volcker Rule has hit the legitimate risk management of Main Street.

Many claim that the Volcker Rule's impact on community and regional banks is limited, as they have little use for trading in products such as derivatives. But that is not the case. According to a Regions Financial and Auburn University study, around 18 percent of community banks were active derivative users by 2012.[18] The same study found that derivatives activities reduced credit and interest risks and improved the profitability at small banks during the financial crisis of 2007-2008.[19]

Banning such activity deters smaller banks from permissible risk management, increasing bank fragility and compliance paperwork. The lack of access to low-cost risk management tools and a growing compliance burden have reduced lending by small and regional banks.[20]

For Investors and IPOs. Over the past 15 years, there has been a troubling decrease in both the annual number of U.S. initial public offerings (IPOs) and the number of publicly-traded companies. As of 2015, there were just 3,700 publicly traded firms with stock listings on U.S. exchanges, among the lowest number of stocks in more than 40 years. This drop-off in the number of publicly-traded firms appears to be solely a U.S. phenomenon, as stock listings on foreign exchanges rose 28 percent from 1996 to 2012, according to the National Bureau of Economic Research.[21]

This shrinkage in publicly-traded firms has widespread economic implications, as IPOs have been found to increase job growth. Fewer publicly-traded stocks translates into fewer opportunities for middle-class investors to build wealth.[22]

In 2012, President Barack Obama signed into law the bipartisan Jumpstart Our Business Startups Act—known by its acronym, JOBS Act—to provide modest regulatory relief to small and midsize public companies from laws such as the Sarbanes-Oxley of 2002 and Dodd-Frank, which have been found to discourage companies from going and staying public. In subsequent years, there have been other bipartisan bills introduced in Congress to ease the burden of regulation for these firms.

But even if some of these rules are relaxed and repealed, the Volcker Rule may impose another burden on firms' ability to launch an IPO. Often, an IPO is launched with the assistance or one or more banks. The bank serves as a "market-maker" by buying a certain amount of stock in the newly public company and holding it until there is a match between a buyer and seller.

Although there is a small exemption for market-making in the Volcker Rule, numerous vaguely worded conditions have to be satisfied to qualify for this exemption. For instance, a bank has to show that its purchase of stock is "designed not to exceed the reasonably expected near term demands of clients, customers or counterparties."[23] This type of open-ended language leaves a bank at the whim of a regulator after a trade is made.

Not surprisingly, banks subject to the Volcker Rule are sharply reducing their market-making to avoid sanctions from regulators that could result from this arbitrary standard. St. Louis-based Stifel Financial is a midsize bank that has served as market-maker in recent years for an increasing number of IPOs, both for smaller firms in the Midwest and for prominent corporations such as real estate services firm Redfin and meal delivery firm Blue Apron. Stifel CEO Ron Kruszewski has stated that the Volcker Rule is forcing his firm to significantly reduce its market-making activity. In March 2017 testimony, Kruszewski told the House Financial Services Committee: "Volcker materially impacts our ability to effectively make markets."[24]

A recent paper by economists from the Federal Reserve Board and Cornell University finds that the Volcker Rule has reduced market-making across the financial industry. "Dealers regulated by the Rule have decreased their market-making activities," the paper concludes. The authors also find that the data specifically rules out other possible causes of this dropoff, such as the Basel III international capital standards.[25]

This reduction in market-making is increasing the cost of capital for firms that attempt to raise money in public markets. Anjan Thakor, finance professor at Washington University in St. Louis, concludes that banks' retrenchment from market making as a result of the rule will particularly hurt smaller firms. "This will reduce market making in precisely those securities where it is most valuable," Thakor notes.[26]

Is There a Better Alternative to the Volcker Rule? The Volcker Rule attempts to address the legitimate concern that big banks can use their implicit government backing to take risky trading positions. It is not risky trading. However, banks' implicit government backing that is the problem. Relying on thousands of pages of rules to manage the safety and soundness of the financial system is a fruitless exercise when the government subsidizes banks' risky bets.

To address the problem of overly risky bank behavior, lawmakers should focus on reforming government guarantees, such as federal deposit insurance, rather than on restricting what banks may or may not do. Regulators cannot possibly know the optimal level of risk that a bank should take, and it is simply unreasonable to expect them to be able to identify which types of risks are beneficial and which are harmful. Centralized, bureaucratic control of risk-taking failed to prevent the last financial crisis, and there is little reason to believe it will prevent the next one. A better approach would make institutions more responsible for the risks they take.

Conclusion. The Volcker Rule was designed to tackle the perceived risky trading of Wall Street banks. Not only was this not a proximate cause of the financial crisis, the Volcker

Rule makes the financial system less safe by impacting market liquidity and risk management. Main Street businesses see their access to capital deteriorate, while consumers see their cost of credit rise. Without adequate access to finance, businesses are never formed, workers are never hired, and local economies suffer.

The Volcker Rule was a mistaken and unnecessary response to the wrong problem. Fortunately, Congress has an opportunity to rectify this. The Economic Growth, Regulatory Relief and Consumer Protection Act, recently introduced by Sen. Mike Crapo (R-ID) would exempt from the Volcker rule banks with a) less than $10 billion in total consolidated assets and b) total trading assets and trading liabilities below 5 percent of their total consolidated assets.[27] While this relief is welcome, the legislation does not go nearly far enough. As noted, proprietary trading, even by the largest Wall Street banks, did not play a significant role in the onset of the 2007-2008 financial crisis. Therefore, Congress should raise the threshold for the Volcker Rule exemption much higher—at least up to the level of Systemically Important Financial Institution designation under Dodd-Frank, currently set at $50 billion in consolidated assets.

A preferable option is full repeal of the Volcker Rule. This is included in the Financial CHOICE Act of 2017 (H.R. 10), which passed the House of Representatives in June 2017.[28] Were that legislation to pass the Senate, it would help bring about a stable and efficient financial system and provide relief to financial institutions, consumers, and investors. Congress should abolish the Volcker Rule.

Notes

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