BEFORE THE

OFFICE OF THE COMPTROLLER OF THE CURRENCY

WASHINGTON D.C. 20024

In the Matter of

The Volcker Rule

Docket No. OCC-2017-0014

COMMENTS OF

THE COMPETITIVE ENTERPRISE INSTITUTE

September 21, 2017

Prepared by:

Daniel Press

John Berlau

Competitive Enterprise Institute

1310 L Street N.W., 7thFloor

Washington D.C. 20005

Daniel.Press@cei.org

On behalf of the Competitive Enterprise Institute (CEI), we are pleased to submit the following comments on the Office of the Comptroller of the Currency's (OCC) proposed revision to the implementation of section 13 of the Bank Holding Company Act, commonly known as the Volcker Rule.[1] While we believe that Congress should repeal the Volcker Rule in its entirety, we applaud the OCC's efforts to revise the rule to ease the regulatory burden – particularly on smaller banks – consistent with the framework of the statute as written.

INTEREST OF THE COMMENTERS

Founded in 1984, the Competitive Enterprise Institute is a non-profit research and advocacy organization that focuses on regulatory policy from a pro-market perspective. A strong focus of CEI is on removing regulatory barriers that disproportionately harm smaller institutions, whether community banks, small businesses, or individual consumers.

CEI is also a leading advocate of a clean and simple regulatory system that enhances market discipline and reduces the reliance on expansive, arbitrary discretion by regulators. Such a regulatory approach is not only detrimental to an efficient and competitive economy, but has historically failed to identify and mitigate risks prior to a crisis.

Finally, it is our belief that the focus of safety and soundness regulation should not be to control the kind of risks an institution takes, but to make institutions more responsible for their own risks. While the Volcker Rule attempts to address legitimate concerns about financial risk and stability, it has merely doubled down on a failed approach, imposing more regulation to mitigate problems created by past regulation.

I. SCOPE OF ENTITIES SUBJECT TO VOLCKER RULE IS TOO BROAD

The Volcker Rule statute was originally aimed at restricting the kind of activities that only the largest banks on Wall Street engaged in. Paul Volcker himself noted that he thought the rule would only impact the four of five largest banks.[2] This was based on a flawed analysis that determined that commercial banks' trading activities were a cause of the financial crisis. Even taking this original justification as given, however, applying the Volcker Rule to every bank, including small and midsized institutions, is unwarranted.

a) Proprietary trading did not cause the financial crisis

[1] The Volcker Rule applies to banks of all sizes, which are generally required to establish an internal compliance program for two provisions: the proprietary trading provision, which prohibits banking entities from engaging in short-term trading of certain securities, derivatives, commodity futures and options on these instruments, and the "covered funds" provision, which prohibits banking entities from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with hedge funds or private equity funds.

[2] Andrew Clark, "Paul Volcker tells Senate: risky banking activity is like pornography," *The Guardian*, February 2, 2010, https://www.theguardian.com/business/2010/feb/02/paul-volcker-senate-banking-testimony.

The Volcker Rule was designed to tackle the risky trading activities of large federally insured commercial banks that suffered during the recent financial crisis. Supporters of the rule claim that this "gambling" of federally insured deposits was a major contributor to the crash.

A look at the types of institutions that failed during the crisis clearly demonstrates the faults in this argument. For example, 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. On the other hand, the commercial banks that failed did so because of sub-prime mortgage lending, not proprietary trading.[3]

Further, during the crisis, the overall share of loan losses was greater than the overall share of trading losses.[4] Therefore, the crisis was not based on risky trading, but on poor lending. The value of mortgage-backed securities crashed because the mortgages that backed those securities had become worthless, not because they were traded.[5]

This has been consistently reaffirmed by both government reports and testimony. A 2011 Government Accountability Office report 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.[6]

Paul Volcker and many of the Rule's authors have recognized that proprietary trading was not proximate cause of the financial crisis.[7] President Obama's Treasury Secretary, Timothy Geithner, noted in congressional testimony:

> If you look at the crisis, most of the losses that were material for the weak institutions – and the strong, relative to capital – did not come from those [proprietary trading] activities. They came overwhelmingly from what I think you can describe as classic extensions of credit."[8]

---

[3] Peter Wallison, "Obama Voted 'Present' on Mortgage Reform," *Wall Street Journal*, October 15, 2008, https://www.wsj.com/articles/SB122403045717834693

[4] Fisher Investments Editorial Staff, "Vexed by the Volcker Rule?" *Market* Minder, November 20, 2013, http://www.marketminder.com/a/fisher-investments-vexed-by-the-volcker-rule/2e5e233d-e6ae-4bd7-b6f4-2664c82ea360.aspx

[5] Daniel Press, "Regulators Mull Changes to 'Volcker Rule' on Bank Investments," Competitive Enterprise Institute Blog, August 9, 2017, https://cei.org/blog/regulators-mull-changes-volcker-rule-bank-investments

[6] U.S Government Accountability Office, "Report to Congressional Committees: Proprietary Trading," July 2011, https://www.gao.gov/assets/330/321009.html

[7] Daniel Gallagher, "Remarks before the U.S. Chamber Center for Capital Markets Competitiveness," U.S Securities and Exchange Commission, January 16, 2013, https://www.sec.gov/news/speech/2013-spch011613dmghtm

[8] American Action Forum, "Volcker Rule is the Wrong Response to the Financial Crisis," May 26, 2010, https://www.americanactionforum.org/insight/uvolcker-ruleu-is-the-wrong-response-to-the-financial-crisis/

Proprietary trading by the largest banks did not cause the financial crisis. The extent to which small banks' propriety trading was the cause is even less apparent. Smaller banks engage in substantially lower levels of propriety trading, if any.[9] Small banks' proprietary trading activities are less likely to be speculative in nature, and more likely to be relevant to proper risk management.[10] Further, the failure of small-to-medium sized banks would pose little systemic risk to financial stability.

The justification for banning propriety trading for large banks is dubious at best. The justification with regard to medium or small sized banks is wholly inadequate. Their trading activities, whether during the crisis or in the present day, are not a systemic threat worthy of enhanced regulation. The recent Treasury report went some way in recognizing this, that "firms that are small or do not engage in significant proprietary trading should not be subject to the Volcker Rule."[11]

b) Small banks benefit from trading

There is substantial benefit in allowing smaller banks to engage in proprietary trading. Small and medium-sized financial institutions generally engage in lower levels of proprietary trading activities. These banks have more conservative capital structures and their costs of using derivatives, whether for risk management or for trading, are proportionally higher. Incidentally, due to their higher costs, small banks are less likely to speculate with derivatives and more likely to use them for risk management.[12]

Empirical studies have found that community banks' derivative activities can successfully reduce credit and interest rate risk, which was pivotal in shoring up profitability during the recent financial crisis.[13] As Jerold Warner of the University of Rochester found in a 1977 study of bankruptcy costs, small banks gains from hedging are proportionally greater than larger banks.[14] Likewise in a National Bureau of Economic Research paper, Gary Gorton and Richard Rosen

---

[9] Federal Reserve, "The Volcker Rule: Community Bank Applicability," December 10, 2013, https://www.federalreserve.gov/aboutthefed/boardmeetings/volcker-rule-community-bank-20131210.pdf
[10] Xuan Shen and Valentina Hartarska, "Financial Derivatives at Community Banks," St. Louis Federal Reserve, October 2-3, 2013a, https://www.stlouisfed.org/~/media/Files/PDFs/Banking/CBRC-2013/Financial_Derivatives_Community_Banks_-XS_and_VH.pdf
[11] U.S Department of Treasury, "A Financial System That Creates Economic Opportunities Banks and Credit Unions," June 2017, https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf

[12] Shen & Hartarska, 2013a
[13] Ibid
[14] Jerold Warner, "Bankruptcy Costs: Some Evidence," *Journal of Finance*, 1977, https://www.jstor.org/stable/2326766?seq=1#page_scan_tab_contents

found during a 1985-1993 analysis of community banks, that derivatives helped mitigate most of their systematic risks through interest rate risk swaps.[15]

However, the difference between large and small banks' use of derivatives is not only due to different business models. Regulatory barriers deterred smaller banks from using derivatives due to the high cost of implementing hedging strategies. Less than 1 percent of community banks used derivatives in 1999, mainly to manage interest rate risk.[16]

Smaller banks derivative activities were partially liberated through banking deregulation in the late 1990s, in particular, the Rigel-Neal Interstate Banking and Branching Act and the Gramm-Leach-Bliley Act. Small banks derivative use surged as a result. According to Xuan Shen and Valentina Hartarska of Regions Financial Corporation and Auburn University, by 2012, "around 18% of the community banks were active derivative users which included 10% of agricultural specialists, 23% of commercial real estate specialists, 17% of mortgage specialists, 24% of multi-specialists, and 15% of non-specialty banks."[17]

Empirical evidence has shown that this increase in derivatives activities reduced credit and interest risks and improved the profitability at small banks during the financial crisis of 2007-08.[18] Further, Shen and Hartarska find that those banks that did not use derivatives could have had higher profits and greater stability during the crisis had they used derivatives.[19]

The Volcker Rule was developed in direct response to the risk taking of the largest banks during the financial crisis. Therefore, it makes little sense to prevent activities that successfully reduced risk for small banks that played little to no role in causing the crisis. As discussed in the next section, while the legislation looked to exempt many of the beneficial activities described above, the rule's implementation has unnecessarily impacted them. This has increased the risks faced by smaller banks, contributed to the wave of bank failures and mergers, and failed to address the aims of the statute.

c) Volcker Rule brings unnecessary harm to small banks

The Volcker Rule's enforcement has been extremely problematic. Former Federal Reserve Governor Daniel Tarullo has said that the rule is too complex to enforce properly.[20] While the legislation tried to preserve the beneficial aspects of trading, with hedging and market-making activities exempt, the final rule made it incredibly difficult to discern whether a particular trade is legitimate or proprietary in nature.

---

[15] Gary Gorton and Richard Rosen, "Bank and derivatives," *NBER Macroeconomics Annual*, 1995, http://www.nber.org/papers/w5100
[16] Shen & Hartarska, 2013a
[17] Ibid
[18] Shen & Hartarska, "Derivatives as Risk Management and Performance of Agricultural Banks," *Agricultural Finance Review*, 2013b
[19] Shen and Hartarska 2013a
[20] Greg Robb, "Fed's Tarullo says Volcker rule may be hurting trading," *Market Watch*, April 4, 2017, http://www.marketwatch.com/story/feds-tarullo-says-volcker-rule-may-be-hurting-trading-2017-04-04

Worse, the implementation of compliance programs challenges all banks to justify their trading under a presumption of guilt, treating any proprietary activity as prohibited unless it fits into narrow exceptions.[21] The American Bankers Association described this compliance approach as creating "islands of permission in a sea of prohibition."[22] That leaves banks running the risk of regulators arbitrarily interpreting legitimate activities as propriety trading. Daniel Gallagher, former commissioner of the Securities and Exchange Commission, further described this approach to compliance thus:

> Rather than carefully examining banks' trading practices to determine which of those practices constitute proprietary trading and which are instead customer-facing activities providing liquidity and reducing the cost of capital, it stretches its definitions of covered activity on an almost punitive basis, as if based on an assumption that any trading that could result in profits for the trading entity must fall within the ambit of the Volcker Rule's prohibitions.[23]

The problem is compounded for small and medium sized banks. Current regulation mandates every bank, regardless of its size or activities, to understand the rule and implement compliance programs. This places a heavy burden on thousands of small banks that do not engage in activities covered by the rule, but must spend valuable resources proving their compliance anyway.

The regulation relies heavily on regulators' interpretation of an ambiguous separation of trading activities. While larger competitors can hire the best lawyers to devise ways of subverting the rule (as discussed in Section II), smaller institutions cannot risk such regulatory uncertainty. It does a small firm no good to make a perfectly legal trade if it will bring more regulatory scrutiny and possible litigation. As a result, smaller banks have had to reduce and even stop using derivatives for risk management. As a 2015 Harvard study found, "community banks have sold assets simply due to uncertainty" as a result.[24] For example, WashingtonFirst Bankshares sold off $2.7 million worth of securities for $700,000 due to the ambiguity of Volcker Rule guidelines.[25]

Banning such activity deters smaller banks from permissible risk management, increasing bank fragility and compliance paperwork. The result of discouraging cheaper off-balance sheet risk management tools is a substitution towards costlier on-balance sheet asset-liability

---

[21] American Bankers Association, "The Volcker Rule: Islands of Permission in a Sea of Prohibition," April 2017, https://www.aba.com/Advocacy/Documents/volcker-rule-white-paper.pdf
[22] Ibid
[23] Gallagher, 2013
[24] Marshall Lux and Robert Greene, "The State and Fate of Community Banking," M-RCBG Associate Working Paper No. 37, 2015, https://www.hks.harvard.edu/centers/mrcbg/publications/awp/awp37

[25] Abha Bhattarai and Catherine Ho, "Four years into Dodd-Frank, local banks say this is the year they'll feel the most impact," *Washington Post*, February 7, 2014, https://www.washingtonpost.com/business/capitalbusiness/four-years-into-dodd-frank-local-banks-say-this-is-the-year-theyll-feel-the-most-impact/2014/02/07/12c7ca48-877e-11e3-a5bd-844629433ba3_story.html?utm_term=.69ba32249af7

management.[26] The benefits of using derivatives for risk management, as discussed in the previous section, have been greatly eroded. This has increased the sensitivity of bank profitability to credit and interest rate risk, the main risks built in to the traditional saving and loans, while also chipping away at the amount of resources a bank can devote to serving customers.

The lack of access of low-cost risk management tools and a growing compliance burden have led to much less lending by small and regional banks.[27] Along with the mountain of other regulations imposed by Dodd-Frank, the Volcker Rule has contributed to the decline of community and regional banking across the United States, with more than one in five banks – a rate of nearly one per business day – disappearing since the enactment of Dodd-Frank.[28] Inevitably, lending that finances local economic development has taken a hit.[29] The financial system is less safe and less efficient as a result.

d) Reduce scope of the rule, tailor to the largest institutions

We support the Treasury Department's recommendation to exempt banking organizations with $10 billion or less in total consolidated assets or less than $1 billion in trading assets and liabilities from the regulation.[30] However, the OCC, in conjunction with the other relevant regulatory bodies, should extend this exemption much further.

As noted, Paul Volcker originally thought that the rule would only impact the largest institutions that engage in significant propriety trading. Yet, the final rule has grown to impact more institutions than intended, many of which pose little risk to the financial system. The focus of the revised rule should define exactly what is prohibited and apply it only to institutions that engage in significant proprietary trading.

We propose that the Volcker Rule should be applied exclusively in relation to documented financial risk. For example, the regulation could be tailored to apply only to those institutions with significant proprietary trading activities, or those institutions with over $500 billion in assets. This would refine the rule's focus to the largest firms who were identified as taking too great risks with proprietary trading. While we strongly believe that Congress should repeal the Volcker Rule, as it rests on a shaky justification and fails to address the fundamental issue of risk taking, restricting its application to the few firms that engage in substantial proprietary trading or documented financial risk would represent a significant improvement.

At a minimum, the regulation should be integrated into the designation of federally insured-commercial banks as Systemically Important Financial Institutions (SIFIs). The legislation was

---

[26] Shen & Hartarska, 2013a
[27] Lux & Greene, 2015
[28] Rob Nichols, "Yes, community banks are struggling under Dodd-Frank," *Politico*, September 6, 2016, http://www.politico.com/agenda/story/2016/09/community-banks-dodd-frank-000197.
[29] Lux & Greene, 2015
[30] U.S Department of Treasury, 2017

drafted to ensure that the trading activities of federally insured institutions would not lead to system-wide failure and taxpayer bailouts. Therefore, it should be applied only to those institutions designated as systemically important. While we would contest that the current, arbitrarily defined $50 billion asset limit for systemically important financial institutions (SIFIs) is an inappropriate threshold that should be raised much higher, if not eliminated entirely, it is a good starting point for achieving the aims of the statute.

Further, the relevant agencies should refine the regulation to clearly focus on what constitutes prohibited activities. This would allow banks to avoid those activities without having to institute compliance programs to prove that every trade, such as legitimate hedging and market making activities, is within the scope of the law. If the regulation cannot clearly determine what is and is not permitted, then the reliance upon arbitrary decisions of regulators becomes inevitable.

II. VOLCKER RULE HAS BEEN INEFFECTIVE AT REDUCING SYSTEMIC RISK

The Volcker Rule has failed to reduce systemic risk in the financial system as Dodd-Frank intended. According to the OCC's request for comment, "The Volcker Rule was intended to promote the safety and soundness of banking entities and prevent taxpayer bailouts by minimizing bank exposure to certain proprietary trading and fund activities that could involve undue risk."[31] There are at least three clear problems with this aim.

First, the types of activities addressed do not involve "undue risk."

Second, it is not obvious that the Volcker Rule has made the financial system any safer. Instead, it has merely relegated trading activities to other sectors, preventing diversification, concentrating risk, and increasing the likelihood of large banks manipulating the regulation.

Third, the statute, as discussed in Section III, does not solve the issue of taxpayer bailouts.

a) A flawed account of financial risk

Trading in securities for a firm's own account and affiliating with private equity and hedge funds does not inherently constitute excessive risk. All financial operations involve risk by definition. 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."[32]

Lending is itself a risk-laden bet with a bank's own capital – a long-term bet on a borrower. This can often be riskier than trading, as we saw during the financial crisis. After all, it wasn't proprietary trading that brought down commercial banks, but the poor extension of credit.

---

[31] Office of the Comptroller of the Currency, "Notice Seeking Public Input on the Volcker Rule," August 1, 2017, https://www.occ.gov/news-issuances/news-releases/2017/nr-occ-2017-89a.pdf

[32] Norbert Michel, "The Volcker Rule was Misguided and unnecessary," Heritage Foundation, June 13, 2017, http://www.heritage.org/markets-and-finance/report/the-volcker-rule-was-misguided-and-unnecessary

Further, as securities have many buyers while individual loans often have none, the liquidity risk on commercial loans is often worse than trading.[33]

While all financial activities involve risk, diversification of activities and revenue streams actually works to reduce risk and make banks more stable.[34] Basic portfolio theory states that combining two risky activities make them less risky combined then they would be separately.[35] 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.

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. The Volcker Rule allows banks to trade in federal, government-agency, and state and municipal bonds. It allows trading in as much junk Detroit municipal debt as possible for their own account, but not for trading on investment grade corporate debt. "Risky trading" is allowed only when it finances government debt.

Regulators cannot possibly know the optimal level of risk that a bank should take. It is simply unreasonable to expect regulators to be able to perfectly identify which types of risks are beneficial and which are harmful. Financial risks are subjective, and restricting institutions from taking the risks they want ends up distorting the pricing of risk throughout financial markets.[36] A better approach would entail making institutions more responsible for the risks they take, not try to centrally control them.

b) The Volcker Rule has not improved the safety and soundness of the financial system

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. For example, some banks have merely increased the risk in their commercial loan books, as opposed to their trading books.[37] It is also perfectly permissible for banks to trade as long as profits are not realized under the rebuttal presumption period of 60 days. There is nothing that prevents banks from reengineering their positions. Indeed, the largest banks with the savviest lawyers and traders have done this.

A recent example comes from a 2015 *New York Times* story on Goldman Sachs. Goldman, in response to the Volcker Rule, reports, the *Times*, has been "quietly coming up with several new

---

[33] Ibid
[34] Ibid
[35] Mark Calabria, "Would Volcker Rule Stem Systemic Risk?" *Cato Daily Podcast*, February 15, 2012, https://www.cato.org/multimedia/daily-podcast/would-volcker-rule-stem-systemic-risk

[36] Michel, 2017
[37] Ibid

ways to put its own money to work in formats that appear to stay on the right side of Volcker."[38] Instead of investing through a private equity fund, Goldman has been using its own capital to jointly purchase real estate abroad, investing longer than 60 days. Bloomberg's Matt Levine, a former Vice President at Goldman Sachs, explains why this doesn't run afoul of the rule:

> Goldman doesn't actually have to own 100 percent of the businesses it invests in. It can partner up with other people to buy those businesses. It just can't invest anyone else's money. It can't sign clients up for a fund, and then decide how to invest the fund. But it can decide how to invest its own money, and then sign clients up to invest alongside it.
>
> That's kind of a tricky distinction, isn't it? You can't *quite* re-create a private equity fund that way, but you can get close. You invest some money, your clients invest some money, you share the risks and the upside, you get paid for putting the deal together.[39]

Recent empirical evidence of the regulation's announcement effects supports the notion that banning risky activities of one sort merely encourages banks to take up risky activities elsewhere. A 2016 study by Jussi Keppo of the National University of Singapore and Josef Korte of Goethe University Frankfurt found that banks slightly wound down their trading books relative to their total assets as a result of the rule. The authors also found that banks did not reduce their overall risk taking. "To keep their risk targets, the affected banks raised the riskiness of their asset returns," note the authors. "We also find some evidence that the affected banks raised their trading risk and decreased the hedging of their banking business."[40]

Bloomberg View's Mark Whitehouse recently analyzed the six largest U.S. banks' trading risk through an adjusted value-at-risk measurement. He found that since 2009, banks' trading operations are only 25 percent less risky, and have actually become riskier over the past year.[41] Given that the regulation came into effect in 2015, it has at best had a minor effect on upon risk taking amongst large, commercial banks.

This is only one part of the story. By reducing diversification in banks and concentrating risk in other financial markets, the Volcker Rule increases systemic risk. That is because the rule has encouraged other entities that are not subject to it to take up proprietary trading. By restricting the proprietary trading of only commercial banks, it has pushed the activity out to less-regulated hedge funds, which do not have access to federally insured deposits. Moving proprietary trading

[38] Nathaniel Popper, "Goldman Sachs Investments Test the Volcker Rule," *New York Times*, January 21, 2015, https://dealbook.nytimes.com/2015/01/21/goldman-investments-are-testing-volcker-rule/?emc=edit_dlbkam_20150122&nl=business&nlid=12532775&_r=1

[39] Matt Levine, "Goldman Sachs Actually Read the Volcker Rule," *Bloomberg View*, January 22, 2015, https://www.bloomberg.com/view/articles/2015-01-22/goldman-sachs-actually-read-the-volcker-rule

[40] Jussi Keppo and Josef Korte, "Risk Targeting and Policy Illusions—Evidence from the Announcement of the Volcker Rule," *Management Science*, November 17, 2016

[41] Mark Whitehouse, "How much have banks really cut their risks?" Bloomberg, September 11, 2017, https://www.bloomberg.com/view/articles/2017-09-11/how-much-have-banks-really-cut-their-risks

from the banking sector to the shadow-banking sector may mask the risks that federally insured banks can take, but it does not improve the overall health of the financial system.

III. THE NEED TO ADDRESS THE MORAL HAZARD OF GOVERNMENT GUARANTEES

A great amount of faith has been placed in the hands of regulators to ensure the safety and soundness of the financial sector by writing and enforcing thousand-page rules. Yet, many such regulatory actions have come in response to some underlying ill-advised government intervention – whether a subsidy, taxpayer guarantee, or an anti-competitive regulation – that encourages risk taking. Too little has been done to address this moral hazard arising from government intervention. Instead, lawmakers and regulators have relied on ever more intervention. The Volcker Rule doubled down on this approach.

a) The fundamental issue is deposit insurance

The Treasury Department all but admitted the cause of such moral hazard in its recent report, "A Financial System That Creates Economic Opportunities," which states: "Banks with access to the federal safety net — FDIC insurance and the Federal Reserve discount window — should not engage in speculative trading for their own account. *Insured banks that engage in proprietary trading enjoy a government-conferred advantage that invites moral hazard*."[42] [Emphasis added]

As noted, there is little evidence that proprietary trading is any riskier than other financial activities. Its role in the financial crisis was negligible, and a Volcker Rule would have done nothing to soften the crash. Note also that proprietary trading is not so dangerous that all types of assets are banned across all industries. The problem is not that proprietary trading is innately too risky, but that commercial banks are trading, in part, with federally insured deposits.

The problem, as the Treasury report admits, is the "government-conferred advantage that invites moral hazard." To deal with the problem of risky banks, lawmakers should focus on reforming government guarantees rather than on restricting what banks may or may not do. While not addressed in the legislation or final rule, federally insured deposits conflict with the aims of the statute, particularly the statute's intention "to promote the safety and soundness of banking entities and prevent taxpayer bailouts."[43]

Both government officials and the academic literature have been highly critical of deposit insurance's role in encouraging risky behavior.[44] It is widely recognized that when deposits are insured, depositors are less likely to care about the safety and soundness of their bank, while banks are shielded from bearing the full cost of their risky behavior.[45]

---

[42] U.S Department of Treasury, "A Financial System That Creates Economic Opportunities Banks and Credit Unions," June 2017, https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf
[43] Ibid
[44] Charles Calomiris and Richard Herring, "Why and How to Design a Contingent Convertible Debt Requirement," Wharton Working Paper, April 19, 2011
[45] Calabria, 2017

In fact, President Franklin Roosevelt, who instituted deposit insurance, worried that these subsidies put "a premium on unsound banking in the future."[46] Current FDIC Vice Chairman Thomas Hoenig has written that deposit insurance is effectively an "enormous subsidy" to banks that "facilitates the use of leverage and provides an incentive toward higher risks that are hidden in opaque instruments, in trading activities, and in derivatives."[47]

The moral hazard effects have only gotten worse in recent years. Dodd-Frank has increased deposit insurance from $40,168 per account in 1934 to $246,706 in 2010 (in 2008 dollars), while the percentage of insured domestic deposits has increased from 45.12 percent in 1934 to 78.87 percent in 2010.[48]

The legislation's solution to risky banks is layering more government regulation on top of a problem created by government regulation. This is not only unnecessary, as proprietary trading activities were not to blame for the financial crisis, but it is also a fruitless exercise that does nothing to address instability in the financial system. Regulators are rightly concerned about the role of perverse incentives, but they should first look to remove the very moral hazards they have established.

b) Scale back federal deposit insurance

In its request for comments, the OCC noted that revisions to the current rule will be undertaken in conjunction with other rulemaking agencies, such as the FDIC.[49] While we recognize that reforms to deposit insurance require statutory change, the relevant agencies should work together to study the moral hazard effects of federal deposit insurance, particularly in regard to trading activities. Below are our recommendations for reforming deposit insurance.

Whereas banks currently face strong incentives to prioritize return over stability, reducing deposit insurance would refocus their attention to offering a healthy balance of risk and return.

The level and scope of deposit insurance has risen dramatically since its inception, up to nearly $250,000, covering almost 80 percent of deposits. Such a high scope largely functions as a subsidy to wealthy individuals, with the top 10 percent of households holding 67 percent of all deposits, while

---

[46] Warren Gibson, "Federal Deposit Insurance: A Banking System Built on Sand," *Foundation for Economic Education*, May 20, 2010, https://fee.org/articles/federal-deposit-insurance-a-banking-system-built-on-sand/

[47] Thomas Hoenig, "A Better Alternative to Basel Capital Rules," working paper, Harvard Law School Forum on Corporate Governance and Financial Regulation, September 28, 2012, http://blogs.law.harvard.edu/corpgov/2012/09/28 /a-better-alternative-to-basel-capital-rules/

[48] Thomas Hogan and William Luther, "Explicit and Implicit Costs of Government-Provided Deposit Insurance," June 13, 2012, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2083662 as cited in Hester Peirce and Robert Greene, "Rethinking the Volcker Rule," *Mercatus On Policy*, January 15, 2013, https://www.mercatus.org/system/files/Rethinking_Volker-Rule_MOP_v1-0.pdf

[49] OCC, 2017

the average account balance of an everyday American is around $5,000.[50] This is up to six times greater than the original 1933 limit of $40,000.[51]

Federal deposit insurance should be scaled back to the $40,000 level as it was originally conceived during the Roosevelt administration. This would ensure protection for the deposits of less wealthy depositors, while large depositors would have a greater incentive to monitor banks' risk; unlike regulators, they would stand to incur losses if the institution failed. This alignment of incentives would more effectively ensure the safety and soundness of financial institutions.

Government-provided deposit insurance should eventually be phased out entirely. However, in the short-term, scaling it back to cover only small retail investors, who hold the overwhelming majority of accounts, would substantially reduce bank risk-taking and lead to greater financial stability.

IV. CONCLUSION

We applaud the Office of the Comptroller of the Currency's efforts to revise its interpretation of section 13 of the Bank Holding Company Act. As discussed, the Volcker Rule has:

- Negatively impacted small and mid-sized banks;
- Failed to improve financial safety and soundness; and
- Failed to address the underlying driver of financial risk and moral hazard: federal deposit insurance.

Accordingly, to better reflect the aims of the statute, we advise the relevant regulatory agencies to:

- Tailor the rule to the largest banks with significant proprietary trading;
- Simplify the definition of prohibited activities, clearly outlining what is prohibited;
- Study the moral hazard effects of federal deposit insurance on bank's risk-taking, particularly trading activities.

[50] Mark Calabria, "Deposit Insurance, Bank Resolution, and Market Discipline," Heritage Foundation, February 28, 2017, http://www.heritage.org/markets-and-finance/report/deposit-insurance-bank-resolution-and-market-discipline
[51] ibid