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The Volcker Rule: Not the Solution to Reducing Financial Risk

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President Obama has reached into the past to try to resurrect failed bank regulatory approaches as a way of raising the stakes on his newly emphasized financial regulatory plan. Referred to as the "Volcker rule" after former Fed Chairman Paul Volcker, who developed the two-part proposal, it would further restrict the size of financial institutions and prevent those with insured deposits from trading in the financial markets on their own behalf.

Unfortunately, neither part of the proposed rule would do anything to improve the stability of the banking system and would have done absolutely nothing to prevent or even to reduce the impact of the 2008 financial crisis. Worse, if implemented, the rule would actually damage the U.S. financial system. Nor would enacting the Volcker rule do anything to prevent future financial problems. Finally, its implementation could reduce the ability of U.S. banks to compete with foreign rivals.

Revisiting Glass–Steagall and Other Old Mistakes. The Volcker rule would prohibit any financial institution from having greater than a 10 percent share of the total overall domestic liabilities in the U.S. financial system. This size restriction is an expansion of an existing rule that prohibits U.S. financial institutions from owning more than 10 percent of all U.S. bank deposits.[1]

Second, it would prohibit any bank or other institution with FDIC-insured deposits from undertaking any proprietary trading—that is, trading for the banks' own behalf rather than for the benefit of a client—or from owning or sponsoring hedge funds or private equity funds.

The fact that this provision applies only to banks is very important. Prohibiting banks from engaging in certain types of financial activities is an old and discredited concept that was once embodied in the Glass–Steagall Act of 1933. Before its repeal in 1999, Glass–Steagall[2] limited banks' ability to meet the needs of their best customers as new, cheaper financing products developed that were outside the scope of their allowed activities. Some banks were weakened through their inability to compete with other types of financial institutions, while eventually other banks found ways around those restrictions. In both situations, Glass–Steagall ended up increasing financial risk rather than decreasing it.

Attempting to reinstate Glass–Steagall-type restrictions represents a fundamental misreading of the causes of the 2008 crisis by assuming that, since the crisis occurred after the repeal of Glass–Steagall, the repeal was a cause of the crisis.

The Volcker rule and similar misguided legislation to reestablish the Glass–Steagall Act assume that a bank should be essentially a utility limited to taking in deposits and making certain types of safe

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loans. They reason that if banks are protected from risky activities, other types of financial services firms can be allowed to fail without causing problems to the overall financial system.

However, these proposals completely miss the point that as far back as the 1998 failure of the hedge fund Long-Term Capital Management, systemic risk to the financial system is less likely to come from banks than from non-banks.

During the 2008 financial crisis and other times of financial stress, none of the major financial firms that failed or had to be rescued did so because of their size or because banks engaged in proprietary trading. Both Bear Stearns and Lehman Brothers, the failures of which signaled the 2008 crisis, were significantly smaller than many other financial institutions, *and neither they nor AIG was a bank.* All three caused systemic risk because of the way that they and their investment products were interconnected to every other significant world financial institution, and their failure either caused or would have caused those other financial institutions to bear major losses. Those financial institutions were in turn interconnected with others, and their losses would have caused still others to collapse until the cascading effects and the fear of future losses could have caused the entire financial system to collapse.

An additional level of instability was caused by many major financial institutions having relatively small amounts of capital available to absorb losses. They also had limited amounts of liquid assets to cover losses and repay the short-term loans that financed many of their activities. Neither the Volcker rule nor restoring the Glass–Steagall Act would do anything to reduce that interconnectedness or to increase liquidity.

The Volcker Rule Hurts Banks Without Providing Any Real Benefit. Besides not reducing systemic risk to the financial system, both parts of the Volcker rule would be exceptionally hard to enforce and would have significant negative side effects. The rule would require very precise definitions for regulators to implement it. If definitions are loose, the rule would be essentially meaningless; overly restrictive definitions, on the other hand, would ban traditional ways that banks serve their customers and manage their assets to ensure that they have sufficient liquidity.

Size Restrictions Would Hurt Competitiveness. The size restriction is an expansion of an existing rule that prohibits U.S. financial institutions from owning more than 10 percent of all U.S. bank deposits. By expanding this to include non-deposit liabilities, the rule seeks to restrict the ability to use borrowed money to finance growth. However, the size of a financial institution does not approximate the risk it imposes on the financial system.

As was discovered in 2008, risk is a function of the investments of a financial institution and how the financial institution is connected to others. None of the financials that failed or came close to failing in 2008 did so merely because of its size. AIG was large, but its systemic risk was caused by the fact that it had sold products to just about every other significant financial institution, and AIG's failure would have caused these others to take large losses.

Restricting the size of U.S. banks through fiat would simply mean that they would be unable to finance large investments by major corporations without teaming up with other financial institutions.[3] This additional complexity and cost would

1. For details on the limitation on the proportion of deposits that can be held by one bank or bank holding company, see Cybil White, "Riegle-Neal's 10% Nationwide Deposit Cap: Arbitrary and Unnecessary," North Carolina Banking Institute, Vol. 9 (2005), pp. 347–372, February 5, 2005, at *http://studentorgs.law.unc.edu/documents/ncbank/volume9/cybilwhite.pdf* (February 11, 2010).
2. For a further discussion of Glass–Steagall, see David C. John, "Gramm-Leach-Bliley Act (S. 900): A Major Step Toward Financial Deregulation," Heritage Foundation *Backgrounder* No. 1338, October 28, 1999, at *http://www.heritage.org/Research/Regulation/BG1338.cfm.*
3. U.S. banks are currently prohibited from loaning more than a set proportion of their capital to any one customer. Since it makes sense to hold capital only if it can be used to generate profits, a size limit as proposed in the Volcker rule would make it much harder for U.S. banks to make loans above a certain size. This is a restriction that banks in other parts of the world would not face.

make it harder for U.S. financial institutions to compete with major European and Asian banks.

Proprietary Trading Is Hard to Define. Supporters of the ban on proprietary trading cite fears that banks will gamble with depositor money or even bet against certain of their customers. Certainly, no one wants banks to engage in risky practices, but the details are critical to determining what is a risky practice and what is an important part of a bank's normal customer service and management of its own liquidity.

Banks have always served their customers by arranging trades of customer assets, and this extends to buying assets that a customer seeks to sell and holding them for short periods until the bank can find a buyer. In addition, a bank needs to invest its own capital and other assets to ensure that it has enough cash on hand for periods of high demand without reducing its earnings.

The difference between these legitimate and traditional activities and those the Volcker rule seeks to ban would be difficult if not impossible to determine. Attempting to do so would require an intrusive, expensive regulatory compliance system that by its nature would micro-manage day-to-day activities without any significant reduction in systemic risk.

A Better Approach to Reducing Financial Risk. Both parts of the Volcker rule are irrelevant to the current debate and potentially damaging to U.S. banks. Policymakers should instead reduce systemic risk through increasing capital and liquidity standards and adopting a new bankruptcy chapter that could facilitate a realistic and permanent resolution of troubled financial services.[4]

The Volcker rule and similar efforts to resurrect the Glass–Steagall Act fail to understand the current financial industry and attempt to return U.S. financial institutions to the way they were organized in the 1930s. By focusing on the wrong questions, they would inevitably fail to reduce financial risk in individual financial institutions or the potential for another financial crisis in the future.

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4. For details, see David C. John, "Using Bankruptcy and Capital Standards to Address Financial Institutions That Are 'Too Big to Fail,'" Heritage Foundation *Backgrounder* No. 2343, November 24, 2009, at *http://www.heritage.org/Research/Regulation/bg2343.cfm.*