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Volcker Rule May Make the Financial and Banking System Riskier

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By now, it should be clear even to casual observers that the Volcker Rule, which was intended to limit the "risky" activities of banks by banning them from certain types of transactions, will be nearly impossible to implement without severe unintended damage to the U.S. financial system and many other types of businesses both here in the U.S. and overseas.

Even though the Federal Reserve now says that banks will not have to fully comply with it until July 2014,[1] they will have to show "good faith planning efforts" to prepare for full compliance in the interim. Combined with the continuing confusion about what the Volcker Rule will actually prohibit, the rule will continue to cause serious uncertainty about the structure and services provided by banks for at least the next two years. Since neither the banks nor the regulators have any idea what the final regulations will say, they will have no idea what constitutes good faith efforts to comply. Because of the continuing confusion and its effects on the financial system, Congress should immediately begin a serious re-examination of the Volcker Rule's likely effect both in this country and abroad and repeal it as quickly as possible.

While many were concerned about the negative effects of the Volcker Rule before the Dodd–Frank financial regulation bill passed,[2] the realities of the situation became clear last October, when four financial regulators[3] jointly issued a 298-page draft regulation[4] that would implement it. The fact that the regulators were extremely unclear themselves about what the Volcker Rule intended them to do and how they were supposed to implement the rule was made clear by the 394 separate questions about various bank services and how they are used by their customers that were contained in the draft regulations.

The situation is so bad that so far, three high-ranking finance officials—including former House Financial Services chairman Barney Frank (D–MA)[5]—have either called for the regulators to scrap the current draft regulations and start over or have urged them to release a greatly simplified version. However, as the comments on the draft regulations show, it would be impossible for the regulators to create workable regulations anywhere close to the July 21, 2012, deadline in Dodd–Frank. In the meantime, the financial institutions that would be most affected are living in limbo,[6] unable to plan for the future with any confidence.

The draft received 383 detailed responses[7] and a roughly 18,500 additional form letters generated by various groups. The detailed responses included submissions expressing concern about the effect of the proposal from a number of foreign governments—including Canada, Japan, the United Kingdom, and the European Union—all of whom are worried that the Volcker Rule would limit liquidity in the global financial system and make it harder for it to recover from the 2008 recession. This concern was echoed by a number of U.S. state and local governments as well as the Municipal Securities Rulemaking Board, which regulates the sale of state and municipal securities. Clearly, the Volcker Rule would have harmful effects on many more entities than its intended

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target and could result in making future financial crises even worse[8] than they would be otherwise.

The Regulators' Delay Will Not Prevent Permanent Damage. Regardless of the status of the regulations and the regulator's delay of the date at which banks must be in full compliance with the Volcker Rule, banks will be legally bound to comply with something that no one really understands. Although the law allows for the phase-in period, the anticipated lengthy delay in the final regulations means that any bank that has made a good faith effort to comply with the law's spirit and guessed wrong would still face a fairly short period to come into compliance and could sustain serious losses. The delay until 2014 really does not change this fundamental problem with the Volcker Rule.

Instead of forcing banks to rely on guesswork, Congress should recognize the Volcker Rule's continuing potential to impose unintended consequences on both the U.S. and international financial markets. The delay prevents the immediate damage if banks had to comply with the original July 21, 2012, implementation date, but it also has the negative effect of increasing the uncertainty that has helped to destabilize U.S. banks. An immediate re-examination of the Volcker Rule will reveal that it was a misguided effort that resulted from a fundamental misunderstanding of the financial system and the role that banks play in it. A full repeal is the only way to correct the situation.

What the Volcker Rule Attempts to Do. Named after former Federal Reserve chairman Paul Volcker, who championed the proposal after the 2008 financial crisis, the Volcker Rule is supposed to make banks safer by prohibiting them from owning or investing in hedge funds or private equity funds or from any "proprietary" trading. Private equity funds typically invest in smaller or start-up companies and, in return for their investment, retain an ownership interest in those companies. Proprietary trading refers to the bank making investments for its own profits rather than on behalf of a client. The Volcker Rule would only apply to banks, not to any other types of financial services firms—including any non-banks that are designated as "too big to fail" by the Financial Stability Oversight Council.

The theory behind the Volcker Rule is that without it banks, being FDIC insured, would be essentially gambling with their capital if they invested in these so-called risky activities. Supporters of the rule believe that banks would be likely to make risky investments because if they made money on the investments, profits and bonuses would go up, but if they lost money, the banks would just be bailed out by taxpayers.

Reality is much more complex than supporters of the rule understood. This is especially true for proprietary trading. While banning any trades not made on behalf of a customer sounds simple enough, the difference between the two may be very hard to determine. The draft regulations consistently use the term "short-term" in defining proprietary trading but fail to define what it means. Thus, if a bank that buys a financial position for a client and then holds it for a time either in hope that the market will improve or to assist another client that will need that kind of financial instrument in the fairly near future, is it complying with the Volcker Rule, or is it in violation? Determining which could be extremely difficult.

1. Ben Protess, "Wall Street Receives Volcker Rule Clarity," *The New York Times*, April 19, 2012, http://dealbook.nytimes.com/2012/04/19/wall-street-receives-volcker-rule-reprieve (accessed April 26, 2012).
2. David C. John, "The Volcker Rule: Not the Solution to Reducing Financial Risk," Heritage Foundation *WebMemo* No. 2810, February 22, 2010, http://www.heritage.org/research/reports/2010/02/the-volcker-rule-not-the-solution-to-reducing-financial-risk.
3. The four agencies responsible for enforcing the Volcker Rule are the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission.
4. *Federal Register*, Vol. 76, No. 215 (November 7, 2011), pp. 68846–68972, http://www.gpo.gov/fdsys/pkg/FR-2011-11-07/pdf/2011-27184.pdf (accessed April 26, 2012).
5. Steven Sloan, "Regulators Should Propose New Volcker Rule, Paredes Says," Bloomberg.com, April 2, 2012, http://www.bloomberg.com/news/2012-04-02/regulators-should-propose-new-volcker-rule-sec-s-paredes-says.html (accessed April 26, 2012).
6. Donna Borak, "Big Banks Push for Early Guidance on Volcker Rule," American Banker, April 2, 2012, http://www.americanbanker.com/issues/177_64/volcker-rule-proprietary-trading-dodd-frank-1048072-1.html (accessed April 26, 2012).
7. Barbara A. Rehm, "The Volcker Rule Needs a Back-to-Basics Makeover," American Banker, March 28, 2012, http://www.americanbanker.com/issues/177_61/volcker-rule-sheila-bair-barney-frank-FSOC-dodd-frank-1047933-1.html (accessed April 26, 2012).
8. Andrew Ross Sorkin, "Volcker Rule Stirs Up Opposition Overseas," *The New York Times*, January 30, 2012, http://dealbook.nytimes.com/2012/01/30/volcker-rule-stirs-up-opposition-overseas (accessed April 26, 2012).

The situation becomes even more confused if the bank serves as a "market maker" for a security. A market maker plays a vital role in ensuring the efficient running of financial markets by both buying and selling that security so that others can be assured of buying and selling opportunities, an activity that requires the bank to own a certain inventory of the security. Market makers operate in both stocks and bonds, as well as foreign exchange and a wide variety of other markets. The draft regulations go to great lengths to try to protect bank involvement with market making, but it is extremely difficult to distinguish between it and proprietary trading. A major fear of foreign, state, and local governments is that the Volcker Rule as implemented would end up reducing banks' ability to perform this role, thus crippling financial markets and in the process making their bonds more difficult to sell.

An Attempt to Go Back to 1930s Banking. The Volcker Rule is a misguided step toward putting banks back into the limited roles that they had 50 and more years ago. In the 1930s, Congress passed the Glass–Steagall Act to separate highly regulated banks from the rest of the financial services sector. However, other types of financial institutions managed to create products that duplicate banking products at a lower cost while Glass–Steagall limited banks to their existing product mix. As banks were forced to offer outdated products to riskier borrowers because their best customers went elsewhere, Glass–Steagall actually made banks riskier than if they had been allowed to compete. This was a major factor in the 1999 repeal of the law.

If fully implemented, the Volcker Rule is similarly likely to backfire and to end up making the financial system riskier than it would have been without it. As with Glass–Steagall, the Volcker Rule's poorly designed attempts to restrict bank activities is likely over time to keep banks from meeting legitimate customer needs, forcing those customers to move their business to other providers. As the dramatic failure of the proposed implementing regulations proves, the simple fact is that today's financial markets are far too complex for such limitations to work.

The longer it takes for Congress to recognize this fact, the greater the damage the Volcker Rule will cause to the financial system—and the more likely that much of that damage will be permanent. Congress should not use the regulators' delay as an excuse for inaction. It is time to repeal this deeply flawed part of Dodd–Frank and to recognize that the Volcker Rule was a mistake.

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