Rolling Out the Volcker Rule

BY TIM SABLIK

In 2010, former Fed Chairman Paul Volcker testified before Congress in support of a regulation to increase stability in the commercial banking sector. The "Volcker rule" is based on a straightforward intuition: Commercial banks should not use insured deposits to fund short-term trading for profit, often referred to as "proprietary trading." Deposit insurance and other forms of government protection of banks give creditors less incentive to monitor the risks that banks take with their money. As a result, banks may take on riskier investments than they otherwise would, and taxpayers could be left with the bill if those investments turn sour.

The 2010 Dodd-Frank Act included a provision requiring the regulators to adopt a regulation along the lines of Volcker's proposal. But it took the five agencies charged with the task — the Fed, the Office of the Comptroller of the Currency (OCC), the Commodity Futures Trading Commission (CFTC), the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission (SEC) — more than three years to complete it. The rule went into effect on April 1, but banks will have until next year to comply.

Weighing in at 71 pages with nearly 900 pages of explanatory preamble, the final rule is considerably more complex than the initial proposal made by the former Fed chairman, due largely to the challenge of delineating between acceptable and unacceptable investments. While the Volcker rule prohibits proprietary trading, it allows banks to trade in stocks or other financial instruments for a variety of other reasons, such as hedging against risk or acting as "market makers." The latter activity, which entails the buying and selling of certain stocks on a regular basis to maintain market liquidity, can be hard to distinguish from proprietary trading.

"The Volcker rule is very complicated because essentially it's trying to regulate something we can't define," says Douglas Elliott, a fellow at the Brookings Institution who specializes in the financial sector and its regulation. "We know proprietary trading when it's occurring in an extreme form. But most of what is done as market making has the same core characteristics."

The "extreme" cases are designated proprietary trading desks at banks, tasked solely with making investments to earn the bank profits. Eliminating such activities while allowing banks to continue desirable functions like hedging and market making is likely what Volcker had in mind when he noted that only a "handful of large commercial banks" engaged in proprietary trading in any great volume. Most large banks closed proprietary trading desks ahead of the final rule's release.

But the rule may have other unintended effects. The regulation prohibits banks from having an ownership interest in certain investment vehicles known as "covered funds," which are any issuers that would be classified as an investment company under the Investment Company Act. Affected investments included collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs), which are commonly held by banks. Some CLOs are structured in a way that could be considered similar to proprietary investments.

The American Bankers Association (ABA) sued regulators in response to the restrictions on CDOs, arguing that they would force community banks to unnecessarily dispose of $600 million in capital. They said banks would take huge losses if forced to sell these investments at once because it would flood the market and depress their value. In response, regulators exempted banks with less than $15 billion in assets from the CDO restriction, and the ABA dropped its lawsuit. In April, the regulators granted larger banks an additional two years to comply with the restriction on CLOs. Even so, the Loan Syndications and Trading Association estimated that banks would have to sell or amend between $50 billion and $55 billion in CLO securities before the deadline.

In April, the House passed a bill to allow banks to continue holding CLOs, but legislation would need to pass the Senate and get President Obama's approval before becoming law.

The final costs of the Volcker rule remain uncertain. In March, the OCC released a cost estimate with a wide range: between $412 million and $4.3 billion. In addition to costs for compliance and regulatory supervision, the estimate includes potential lost market value from banks' investments in restricted assets like CDOs and CLOs, which accounts for much of the uncertainty in the range.

The benefits of the rule are also somewhat unclear. While many analysts agree that allowing banks to use insured deposits to conduct proprietary trades puts taxpayers at risk, it is not clear that it was a major contributor to the financial crisis of 2007-2008. In July 2011, the Government Accountability Office released a study that found that banks suffered some losses from proprietary trading during the crisis, but those losses were a small fraction of the losses from other activities.

Elliott says requiring regulators to determine which banking activities to prohibit and which to allow on a case-by-case basis is the main drawback of the rule. Instead, he advocates using rules like the Basel III capital accords that assess the risk levels at institutions and mandate adequate capital requirements to manage that risk.

"By not forbidding something entirely, you allow it to still happen if it makes underlying economic sense," he says. "And that gives you the opportunity to revisit it later and discover whether there are actually advantages to that activity." **EF**