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BANKTHINK

There Must Be a Better Way to Comply with the Volcker Rule

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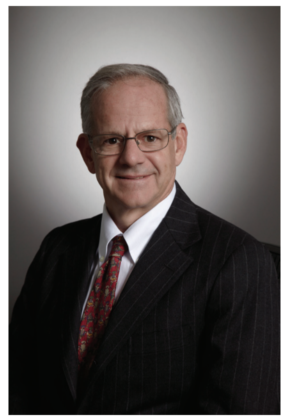

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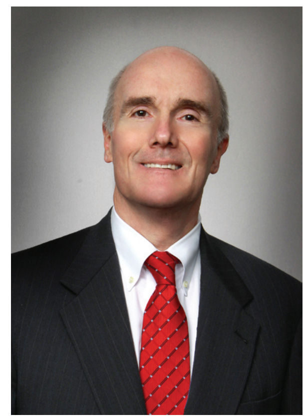

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Former Federal Reserve Board Chairman Paul Volcker has submitted a comment to the interagency rules that were proposed to implement Section 619 of the Dodd-Frank Act, commonly known as the Volcker Rule. The Chairman's comment, together with the many other comments, should remind us—and the regulators—of the importance of focusing on the policy that animates the Volcker Rule.

That core policy should be the avoidance of the threats to financial stability that result from proprietary trading and the accompanying costs to taxpayers from supporting institutions that engage in proprietary trading. Leaving aside whether we agree with the central assumption of the Volcker Rule—that proprietary trading amplified, if not caused, the financial crisis—this policy is now memorialized in statute, and the regulators are obliged to implement it.

The question is how. The mechanisms for attaining these goals need not be overly burdensome. The proposed regulation, however, would be unnecessarily burdensome in the extreme.

The Fed, the FDIC and the OCC together estimate the total burden hours for the banking industry to implement the regulation to be over 6.5 million hours, including about 1.8 millions hours per year after initial implementation. This remarkable estimate even exceeds the Board's estimate for the ongoing burden of regulations under the Truth in Lending Act, which applies to almost all consumer credit transactions, when it implemented the Credit CARD Act of 2009.

There are several reasons why the current regulatory approach is ill-conceived and likely to be counterproductive.

First, the systemic regulation provisions of Title I of Dodd-Frank will be the primary bulwarks against future financial crises. These bulwarks include designation of systemically important institutions subject to more stringent regulatory standards and requirements, and more stringent regulation of certain financial activities through higher capital, stress-testing and resolution plans, to name just a few of its requirements. Viewed in this broader context, the extraordinary compliance burdens that would result from the proposed rule are unwarranted.

The regulators historically have supervised banks through the application of safety-and-soundness principles. Specific quantitative measurements by all or most banks are required either in connection with regulatory capital or when the statute calls for relatively simple ratios, such as those relating to affiliate transactions. They have no place, however, in the identification and measurement of financial activities where there are no clear definitions.

Moreover, while requiring all banks in a particular class to record granular data on a daily basis and report it monthly, the proposed rule recognizes that no particular data are dispositive and that the regulators don't even know at this time what data will be relevant.

As some of the commenters have noted, several data elements will not enable the regulators in any meaningful way to distinguish permissible from impermissible trading. The result is a potential compliance burden for all banking entities that not only may be ineffective, but also is wildly disproportionate to any threat to the financial stability posed by these activities.

Second, Mr. Volcker's discussion of the risks presented by proprietary trading suggest that one reason for his support of the proposed regulation is a desired return to some form of "golden age" of commercial banking, when banks simply intermediated payments, provided a safe depository for liquid assets, and made loans to businesses and individuals. His observations do not address the fact that bad loans had far more to do with the recent crisis than did proprietary trading.

Another problem with this argument is that banks historically have been able to trade and invest in a broad range of securities and financial instruments without any significant evidence that these activities were destabilizing either to banks or the banking system.

For example, banks have been able to invest in bank-eligible securities that they may hold for a shorter or longer period of time. The existing regulatory framework, with its favorable capital and other regulatory treatment of these investment activities, not only tolerated but actively encouraged these activities. The Volcker Rule itself does not limit investing in, or trading of, government securities. The proposed rule, however, intrudes into all of these permissible activities.

Third, the proposed rule not only reduces liquidity that resulted from proprietary trading but also effectively throws sand in the gears of underwriting and market-making, two important sources of market liquidity—the ability to buy and sell assets in a prompt, orderly and efficient manner—that are exempt under the Volcker Rule. The proposed rule introduces a complex set of quantitative and qualitative factors that measure compliance on an after-the-fact basis. Banking entities will become more reluctant to engage in permitted trading activities, especially in transactions involving illiquid instruments, which is precisely where their liquidity function is most needed.

Mr. Volcker's comment suggests that even if the proposed rule reduces market liquidity, so much the better, since excess market liquidity will encourage high-risk trading. What constitutes "excess" liquidity he does not say, but in any event, the depth of the financial crisis owed much not to too much liquidity but to illiquidity. In response, the Dodd-Frank Act and Basel III attempt to foster liquidity of bank balance sheets, including bank assets. Moreover, if market liquidity is excessive (however determined), that is a macroeconomic problem best addressed through the Federal Reserve's monetary policy functions and not through a microeconomic regulatory device such as restrictions on particular banking activities.

Finally, Volcker's letter (downloadable as a pdf file here) acknowledges that only a few, possibly six, banking institutions trade (or have traded) proprietarily "in any real volume." That volume accounts for an estimated 93% of trading revenues. So why is it now necessary to impose an enormous and potentially disruptive burden on the entire banking industry?

Rather than focus on these institutions in the contexts of the more stringent standards under other parts of Dodd-Frank and of the on site examinations of these institutions, the proposal would require every U.S. banking organization to engage in some form of Volcker Rule compliance. Thus, by its own terms the proposed regulation takes a broad and highly prescriptive tack, one that is not required either by the statute or its underlying systemic risk mitigation policy.

Banks that conduct no trading face compliance requirements that go beyond the types of policies and procedures typically required for a bank to avoid a regulatory violation. In addition to adopting such policies and procedures, a bank must anticipate its compliance obligations before making a business decision to trade. Many banks will find it necessary to create and maintain a compliance framework now in case they ever decide to trade.

For banks engaged in trading covered by the Volcker Rule, regardless of the trading volume, the proposal would require a six-point program, including independent testing for compliance. Further, these banks must look to the compliance programs of the largest banks as models. These requirements apply even to those banks that trade solely in U.S. government securities or solely for hedging purposes. Full-blown compliance programs, requiring the production of detailed quantitative data and elaborate compliance regimes, would be necessary for institutions over the $1 billion asset mark, with a few additional requirements for those over the $5 billion threshold.

Perversely, the compliance framework presumes that a banking entity has violated the Volcker Rule unless the entity can prove otherwise – an approach that is the opposite of how the agencies regulate other banking activities. Almost none of these compliance requirements would regulate the substance of the trading activities permitted by the Volcker Rule. Rather, a banking entity must incur potentially significant compliance costs simply to prove that it has not violated the rule.

In sum, arguments such as those in Chairman Volcker's letter point the regulators precisely in the wrong direction. And it is not "futile stonewalling" that is motivating responsible critics of the proposed regulation. The Volcker Rule is just one of several tools that the regulators must use to address systemic risk. In this light, a principles-based approach is far more likely to be effective than the prescriptive, quasi-bright-line approach in the proposal.

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