COMMENT

Volcker Rule Attracts Critics Across Industries While Banks Prepare for Implementation

Michael Greenberger, University of Maryland Law professor and former technical adviser to the UN and director of the Commodity Futures Trading Commission's division of trading and markets, says while changes still need to be made to the Volcker Rule to minimize complexities, banks need to be prepared for the end of "risk free" proprietary trading.

What started out as a three-page proposal by former Fed Chair Paul Volcker has been transformed into a 293-page proposed regulation bringing a response of over 16,000 comment letters.

The key triggering event for this activity is Section 619 of the Dodd-Frank Act, known as the Volcker Rule. Proposed by President Obama well over a month after passage of the House version of Dodd-Frank, the late introduction of this concept was doubtless a reaction to the previous November's surprising loss of a Democratic seat held for decades by late Massachusetts Senator Ted Kennedy.

The political post mortem of that defeat made it clear that the public was outraged that, in Justice Louis Brandeis's words, "Other People's Money" (read "insured customer deposits") was used by the big financial institutions to trade for their own account, leading to large "privatized profits and socialized losses."

That is, these institutions used costumer deposits and the safety net of the Fed window to place highly risky bets on subprime mortgage instruments, which when successful, led to outsized bonuses for bank traders; but, when those bets collapsed, led to the largest taxpayer bailout in U.S. financial history.

A surprising part of the public's anger focused on the seemingly technical 1999 law that repealed the Glass-Steagall Act (GSA). The Volcker Rule was designed to accommodate the GSA concepts to what Mr. Volcker saw as modern day economic needs. Section 619 bans bank proprietary trading in, for example, equities and derivatives with exceptions permitted for underwriting or the making of markets in financial instruments and investment in U.S. securities.

Bank ownership of hedge funds and private equity is limited to 3 percent; and banks are prevented from conducting trades in conflict with their customers. Moreover, all permissible proprietary trading under the Volcker Rule must be done in a fashion that does not jeopardize the economy (i.e., present systemic risk).

While much attention has been focused on Wall Street's many and lengthy written critiques of the rule proposal, not enough has been said about letters from advocates representing the broader public (e.g., Americans for Financial Reform (AFR), Better Markets, and Occupy Wall Street) arguing that the rule is far too weak.

For example, AFR (representing a group of 250 unions, consumer and public interest groups) complains that the proposed definition of "proprietary trading" is so lax that it authorizes trading in the very "complex, illiquid mortgage backed securities" and the "large short bets on the housing market" through "huge volumes of synthetic CDOs that broke the link between real economy activity and securities issuance while involving severe conflicts of interest with clients."

A prominent banking analyst recently estimated in the Financial Times that the proposed implementation of the rule "could knock 20 to 25 percent off banks' earnings." Indeed, what the New York Times recently called the most "unusual critics" of the rules, almost 30 large non-financial companies (including the owners of Red Lobster restaurant, Macy's and Safeway and organized by the Chamber of Commerce), charged that the proposed rule "will impede ability to raise capital and manage risk[.]"

Perhaps the most deft and noteworthy response to these criticisms comes from Mr. Volcker himself. In the Feb. 13 Financial Times Mr. Volcker rebuts a threat to liquidity: "[T]here are and should be thousands of hedge funds and other non bank institutions ready, willing and able to undertake proprietary trading in unrestricted securities in large volumes. [T]hose traders [will] not have access to the taxpayer support implicit in the safety net of commercial banks."

Despite the written complaints of banks, events in the real world show their plan to accommodate the rule. For example, on Jan. 27, the New York Times reported that Citigroup "is shutting its equity principal strategies desk" with its head trader "making plans to start his own hedge fund . . . Citigroup is one of many Wall Street firms to exit the proprietary trading business ahead of the Volcker rule." Moreover, the Financial Times reported that Goldman's CFO was telling an industry conference that Goldman had a "decidedly brighter view of the banking industry's future under the Volcker regime."

He outlined an attractive "Volckeresque model" evidenced by Goldman's winning of the right to make a market in the sale of the $6.2 billion in mortgage bonds acquired by the Fed during the bailouts.

As AFR made clear, pre-Volcker Rule liquidity "was marked by low level of business investment and what in retrospect was a massive capital misallocation into residential investment . . . with no corresponding growth in the real economy."

As to widespread complaints by foreign sovereigns that the rule discriminates against them by allowing U.S. bank trading in U.S., but not in sovereign, debt, Mr. Volcker asks "can it really be of concern that some of the largest [foreign] banks ... cannot maintain effective markets in sovereign debt," or that U.S. banks cannot "make markets" in those transactions? He is also "morally certain" that when the GSA absolute ban on U.S. commercial bank trading was effective, no foreign governments complained that there was insufficient liquidity for sovereign debt.

In the last analysis, changes will be made in the proposal. It is far too complex to remain as is. But, U.S. regulators have shown by actions both formal and informal that so-called "risk free" proprietary trading has done severe harm to the economy. Significant delays do not appear to be on the cards; and the banks are acting (if not writing letters) accordingly.