Center for American Progress

ECONOMY

Making the Volcker Rule Count

This Is the Key Ingredient to Financial Reform

By Pat Garofalo | June 23, 2010, 9:00 am

AP/Susan Walsh

President Barack Obama, flanked by Vice President Joe Biden, and White House adviser Paul Volcker, speaks during a meeting of the President's Economic Recovery Advisory Board earlier this year.

The congressional conference committee reconciling the House and Senate versions of Wall Street reform legislation is scheduled to resolve some of the more contentious aspects of the reform effort this week, including consumer protection and the regulation of derivatives. But also on the docket is perhaps the most crucial reform of all—ironing out differences regarding the Volcker rule, a regulation meant to rein in risky trading by large financial institutions that can undermine financial stability.

In principle, the Volcker Rule—named after former Federal Reserve chairman and current Obama administration adviser Paul Volcker—would prevent almost all big financial institutions from engaging in proprietary trading, or trading for their own benefit, with funds that are guaranteed by the federal government. The Obama administration envisioned that the rule would prohibit proprietary trading at any insured depository institution or financial services company that is treated as a bank holding company, and ban those same institutions from sponsoring or investing in hedge funds or private equity firms.

The overarching goal would be to ensure that federally backstopped institutions stick to core banking practices such as lending and deposit taking while removing the federal safety net from riskier activities that are divorced from customer services. This is an important reform of the financial sector because such trading endangered financial companies that were too big and interconnected to fail, thus necessitating federal rescues, and was also one of the practices that helped inflate the housing bubble.

As the Political Economy Research Institute at the University of Massachusetts points out "risky proprietary investments by investment banks, along with trading for clients whose decisions were influenced by these banks, was one of the main forces that sustained upward pressure on securities prices in the bubble…Indeed, by running large trading books, banks had inside information on client trading patterns and could use that information to front-run, and thereby help sustain market trends," PERI found.

Both the House and Senates' respective reform bills craft a proprietary trading ban, but in different ways. The Volcker rule was formally introduced after the House had already passed its legislation, so the bill only gives the Federal Reserve the power to ban proprietary trading that it deems can threaten systemically risky institutions. The Senate bill, meanwhile, directs federal bank regulators to first study and then potentially implement a ban if they decide it is necessary.

There is, however, a third version of the rule, proposed by Sens. Jeff Merkley (D-OR) and Carl Levin (D-MI). Their proposal would directly implement a ban, not giving regulators the final say over whether or not the rule comes into effect. It sets a floor beyond which regulators are not able to weaken the rule, and only allows banks to engage in proprietary trading in very limited circumstances and only if they set aside additional capital to cover potential losses.

Legislating the ban, rather than leaving it up to the discretion of regulators, is important as it's conceivable that once the financial crisis fades from memory regulators will face pressure from the financial services industry to weaken the rule. In fact, Volcker himself warns that it is unwise to leave implementing a ban up to the regulators because they would not be inclined to act until a financial crisis actually hit, at which point it would be too late for the ban to be effective.

"In my opinion, it's very unlikely that the regulators and supervisors would evoke a strict prohibition until a crisis came and then it's too late," Volcker explains. "That's why you want it in legislation… Look, I've been a regulator for 20 years. So I know how they are."

House Financial Services Chairman Barney Frank (D-MA), who is also chairing the conference committee, believes the Levin-Merkley plan could be where the committee ultimately settles. "I would say the general direction that Senators Merkley and Levin were moving in is a direction a lot of people are supportive of, but the final version, we'll see," he says. "It will be tougher than the House. The House simply empowers the regulators."

The financial services industry is sufficiently concerned about the implementation of the Volcker rule to take its invective about it to the press (shielded by anonymity, of course). "How can they start with something that was never voted on?" asked one "incredulous" Wall Street executive referring to the Levin-Merkley version of the plan, which can technically be added during the conference's own distinct amendment process.

If the financial services lobby can't defeat the Volcker rule outright, they plan to enlist the help of conservative lawmakers who are seeking to riddle it with loopholes and exemptions. Though the stated goal among these conservatives is to exempt money management firms such as Fidelity Investments and State Street Corporation from the regulation, the actual exemption they've suggested is wider, allowing banks to continue to invest in, own, and potentially run their risky activities out of hedge funds and private equity firms.

It makes sense that opponents of a strict Volcker rule would point to non-Wall Street firms such as State Street, which mostly engages in securities administration and stock lending, to make their case. But as Raj Date of the Cambridge Winter Center for Financial Institutions Policy points out, State Street is the perfect example of a smaller institution that became systemically important, engaged in risky trading, and was only rescued due to funding backstops provided by the Federal Reserve and the Federal Deposit Insurance Corporation. Thus, the firm should be subject to a proprietary trading ban. The Roosevelt Institute's Mike Konczal explains further that:

> The temptation to take a boring business line, like [State Street's] custodial mechanism for record-keeping among equities and bonds, or the boring insurance lines of AIG, and stick a giant hedge fund or shadow bank on top of it is going to be too much for businesses. And

> when the temptation is too much for businesses, it's going to be too much for regulators to make the call. Hence why we want to write these rules into the bill, and failing that, as close to the bill as reasonably possible.

As Volcker explains, "the problem with making the exceptions with plausible cases by individual institutions is once you begin, you can never stop. And if you make enough exceptions, you no longer have a rule." And a strong Volcker rule is necessary to creating a financial system that works in the 21st century.

Pat Garofalo is an Economics Researcher at the Center for American Progress and a Blogger at the Center for American Progress Action Fund.

For more information, see:

- No Gambling With Federal Funds
- Financial Reform End Game: Time for Congressional Leaders to Protect Consumers

Center for American Progress