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# ISSUE BRIEF

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## The Volcker Rule Was Misguided and Unnecessary

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The U.S. House of Representatives has passed the Financial CHOICE Act, a major financial regulatory reform bill.[1] One of the key reforms included in the bill is the repeal of section 619 of the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act. Section 619 required implementation of the Volcker Rule. Proponents continue to tout the Volcker Rule as a vital feature of Dodd–Frank that improves the safety of financial markets. However, a careful examination reveals that the Volcker Rule was both misguided and unnecessary.[2]

### The Volcker Rule

Section 619 of the Dodd–Frank Act required federal regulators to implement what is known as the Volcker Rule. This rule prohibits banks, with certain exceptions, from engaging in proprietary trading. The idea is to limit banks' ability to make securities trades solely for their own account rather than for their customers. The rule also prohibits, with exceptions, banks from investing in certain "covered funds," such as hedge funds and private equity funds.[3]

Partly due to the difficulty in distinguishing between proprietary trading and providing trading opportunities for customers (market making), the final rule includes exemptions for certain activities. These activities include "market making, underwriting, hedging, trading in certain government obligations, and organizing and offering a hedge fund or private equity fund, among others."[4] Additionally, proprietary trading is still allowed in U.S. government, agency, state, and municipal bonds, as well as foreign sovereign debt instruments. There is evidence that the Volcker Rule has decreased banks' proprietary trading activities, but this outcome is not necessarily a positive result.[5]

### A Faulty Concept of Risky Activity

Because financial risks are subjective, government-imposed rules that prevent people from taking risks they want to take end up distorting the pricing of risk throughout financial markets. Regulations such as the Volcker Rule produce negative outcomes because they rely on subjective distinctions between types of financial risk. Although it seems logical to stop federally insured banks from making risky bets, every commercial loan *is* a risky bet on whether the borrower will repay the loan.

Although some aspects of commercial lending may seem safer than short-term securities trading, commercial lending typically creates more liquidity risk than securities trading. While regularly traded securities in general have many buyers, individual commercial loans typically have no buyers.[6] Thus, restricting a bank to one type of risky activity can actually increase its overall risk. At the same time, this restriction creates a second specialized entity for securities trading, resulting in two types of financial entities that cannot fully diversify their risk.

Separately, because banks must take risks to remain profitable, any regulation that prohibits

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some types of risky activity is likely to lead to an increase in other types of risky activity. Imposing an outright ban on proprietary trades, for instance, could cause some banks to increase the risk in their commercial loan books as they strived to maintain the same profitability. Indeed, some evidence shows that banks acted in precisely this manner before the Volcker Rule was even fully implemented.[7]

## A Simpler Version of Volcker Already Existed

It runs wholly counter to the conventional narrative surrounding the 2008 financial crisis, but federal regulators had the authority to regulate proprietary trading ever since Congress passed the 1933 Banking Act, otherwise known as the Glass–Steagall Act. Specifically, section 16 of Glass–Steagall, which Congress did not repeal, provided the necessary authority to regulate proprietary trading.[8]

Section 16 prohibited:

- Nationally chartered banks from securities dealing except for buying or selling securities "without recourse, solely upon the order, and for the account of, customers."[9]
- Nationally chartered banks from purchasing investment securities for their own trading account *except* "under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe."[10]

The Comptroller did issue rules regulating "money market investments and securities purchased by the bank for its own account."[11] Several key passages from the rules, taken verbatim, are as follows:

- "Investments, like loans, are extensions of credit involving risks that carry commensurate rewards. However, risks in the investment portfolio should be minimized to ensure that liquidity and mar-

1. Alan Rappeport, "Bill to Erase Some Dodd-Frank Banking Rules Passes in House," *The New York Times*, June 8, 2017, https://www.nytimes.com/2017/06/08/business/dealbook/house-financial-regulations-dodd-frank.html (accessed June 9, 2017).
2. The record also shows that the Volcker Rule was added to Dodd–Frank as part of a last-minute political compromise, and that federal regulators did not believe the rule was necessary. See Kimberly D. Krawiec and Guangya Liu, "The Volcker Rule: A Brief Political History," *Capital Markets Law Journal*, Vol. 10, No. 4 (2015), pp. 507–522, http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=6191&context=faculty_scholarship (accessed June 9, 2017).
3. See *Federal Register*, Vol. 79, No. 21 (January 31, 2014), pp. 5535–6076.
4. News release, "Final Rules to Implement the 'Volcker Rule,'" Board of Governors of the Federal Reserve System, Commodity Futures Trading Commission, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Securities and Exchange Commission, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20131210a3.pdf (accessed June 9, 2017).
5. See Jack Bao, Maureen O'Hara, and Xing (Alex) Zhou, "The Volcker Rule and Market-Making in Times of Stress," Finance and Economics Discussion Series 2016-102, Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2016.102 (accessed June 13, 2017).
6. Like other financial intermediaries, banks pool individuals' funds and channel the money to others who need capital to operate; they cannot fulfill this role without taking financial risks. See Norbert J. Michel, "Glass–Steagall Separation Did Not and Will Not Make Markets Safer," Heritage Foundation *Issue Brief* No. 4699, May 3, 2017, http://www.heritage.org/sites/default/files/2017-05/IB4699_0.pdf, and Norbert J. Michel and David R. Burton, "Financial Institutions: Necessary for Prosperity," Heritage Foundation *Backgrounder* No. 3108, April 14, 2016, http://www.heritage.org/markets-and-finance/report/financial-institutions-necessary-prosperity.
7. Jussi Keppo and Josef Korte, "Risk Targeting and Policy Illusions—Evidence from the Announcement of the Volcker Rule," working paper, June 2016, http://dx.doi.org/10.2139/ssrn.2466477 (accessed June 9, 2017).
8. Four sections (16, 20, 21, and 32) of Glass–Steagall separated commercial and investment banking in the U.S., and the 1999 Gramm–Leach–Bliley Act (GLBA) repealed only two of these sections, leaving sections 16 and 21 intact. See Norbert J. Michel, "The Glass–Steagall Act: Unraveling the Myth," Heritage Foundation *Backgrounder* No. 3104, April 28, 2016, http://www.heritage.org/markets-and-finance/report/the-glass-steagall-act-unraveling-the-myth.
9. The Banking Act of 1933, 12 U.S. Code 24 § 16.
10. Ibid. Section 16 also included several statutory restrictions on how much of these activities the Comptroller could allow. For example, the Comptroller was limited so that "in no event…shall the total amount of the investment securities of any one obligor or maker…held by the association for its own account exceed at any time 15 per centum of the amount of the capital stock of the association actually paid in." Additionally, the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) requires that any FDIC-insured state bank not engage in any activity impermissible for national banks (12 U.S. Code § 1831a)—and nearly all state banks are FDIC-insured.
11. See Comptroller of the Currency, "Comptroller's Handbook (Section 203): Narrative and Procedures," in *Investment Securities*, March 1990, https://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/investsecurities1.pdf (accessed June 9, 2017).

ketability are maintained. Bank management must recognize that the investment account is primarily a secondary reserve for liquidity rather than a vehicle to generate speculative profits. Speculation in marginal securities to generate more favorable yields is an unsound banking practice."[12]

- "National banks are governed in their security investments by the seventh paragraph of 12 USC 24 and by the investment securities regulation of the Comptroller of the Currency (12 CFR 1). The investment securities regulation defines investment securities; political subdivision; general obligation; and Type I, II, and III securities, and establishes limitations on the bank's investment in those securities. The law, 12 USC 24, requires that for a security to qualify as an investment security, it be marketable and not predominantly speculative."[13]

- "For its own account…[t]he purchase of Type II and III securities (see 12 CFR 1.3(d) and (e)) is limited to 10 percent of capital and surplus for each obligor when the purchase is based on adequate evidence of the maker's ability to perform. That limitation is reduced to 5 percent of capital and surplus for all obligors in the aggregate where the purchase judgment is predicated on 'reliable estimates.'"[14]

- "Shares of investment companies whose portfolios contain investments subject to the limits of 12 USC 24 or 84 may only be held in an amount not to exceed 10 percent of capital and surplus. That is, a bank may invest only an amount not to exceed 10 percent of its capital and surplus in each such investment company."[15]

Separate from whether such regulations are effective or appropriate, the fact remains that, prior to Dodd–Frank, federal regulators used their existing authority to regulate proprietary trading and to ensure commercial banks only conducted a limited amount of such activities.[16]

## Conclusion

The Financial CHOICE Act repeals the Volcker Rule. Advocates argue that the Volcker Rule is a vital piece of how Dodd–Frank improves the safety of financial markets. A careful examination, however, reveals that the Volcker Rule was both misguided and unnecessary.

The Volcker Rule supposedly protects taxpayers by prohibiting banks from engaging in proprietary trading—that is, making risky investments solely for their own profit. Although it seems logical to stop banks from making risky bets with federally insured deposits, banks make risky investments with federally insured deposits every time they make a loan—after all, there is always a chance a borrower will default. Prior to the passing of Dodd–Frank, federal regulators already had—and used—the authority to regulate proprietary trading. In short, a much simpler version of the Volcker Rule already existed.

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12. Ibid., p. 2.
13. Ibid.
14. Ibid.
15. Ibid., p. 4.
16. Additional restrictions, such as § 23a and § 23b of the Federal Reserve Act, existed prior to Dodd–Frank, and further limited the extent of proprietary trading. Section 23a limits the aggregate amount of transactions the bank (and its subsidiaries) can conduct with any affiliate to no more than 10 percent of the bank's capital stock and surplus, and also limits the aggregate amount of transactions the bank (and its subsidiaries) can conduct with all affiliates to no more than 20 percent of the bank's capital stock and surplus. Section 23b restricts financial transactions between affiliates so that the relationship is not used simply to gain preferential terms or treatment relative to what would be available by interacting with, instead, nonaffiliated companies. See 12 U.S. Code § 371c and 12 U.S. Code § 371c–1.