The Volcker Rule

Islands of Permission in a Sea of Prohibition

American Bankers Association®

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The Core Principles for Regulating the United States Financial System, enumerated in Executive Order 13772, include the following that are particularly relevant to an evaluation of current U.S. fair lending rules and regulatory practices:

(a) empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;
(b) prevent taxpayer-funded bailouts;
(c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry;
(d) enable American companies to be competitive with foreign firms in domestic and foreign markets;
(f) make regulation efficient, effective, and appropriately tailored; and
(g) restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework.

The American Bankers Association[1] offers these views to the Secretary of the Treasury in relation to the Directive that he has received under Section 2 of the Executive Order.

- **The complexities and vagueness of the Volker Rule make it a drag on the economy.**
- **The Volcker Rule should be repealed.**
- **Until repeal legislation is enacted, revise rules to mitigate harmful effects on the economy.**
- **The Rule should be refocused on what is prohibited rather than a neo-quixotic search for what is permitted.**
- **Application of the Rule should be tailored to focus solely on systemic risk.**
- **The Secretary of the Treasury should employ his good offices to facilitate agency coordination in implementation of the Volcker Rule.**

[1] The American Bankers Association is the voice of the nation's $17 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits, and extend more than $9 trillion in loans.

Introduction

Since the earliest days of the Republic, banks have been chartered by government to perform a variety of essential financial functions, for which banks have developed highly skilled competencies, continually updated and refined. These include (among others)—

- Financial Intermediation (Linking Borrowers with Savers)
- Maturity Transformation
- Custodial Services
- Trust Services
- The Payments System
- Capital Formation
- Liquidity Provision
- Cash Management
- Government Finance
- Wealth Management

For example, banks make investments to manage potential mismatches between the maturities of their assets (mostly loans) and their liabilities (mostly deposits), a practice known as "asset-liability management." Banks intermediate in the capital markets through making markets in financial instruments, like corporate bonds, to facilitate liquidity, price discovery, and capital formation. Banks make investments that hedge, or reduce, the risk of loss for themselves and for their customers, as well as invest together with customers and other investors in private funds designed to finance start-up businesses or fund projects for the public welfare. Despite the useful and proper purposes of these investment activities by all banks, they have been caught up in the Volcker Rule's restrictions on "proprietary trading" that were directed at very different investment activities.

Following the financial crisis, the previous Administration, in connection with systemic worries, raised concerns about what it identified as complex, "excessively risky" proprietary trading in securities and proposed enactment of what became Section 619 of the Dodd-Frank Act, known as the Volcker Rule. Banks, however, were already subject to a very constrained investment and trading environment leading up to the financial crisis. Reforms enacted during the Great Depression established restrictions on bank investments and activities, and these have largely remained in place. Nevertheless, the Volcker Rule was layered on top of existing constraints to prohibit banks and their affiliates from engaging in proprietary trading and from conducting proprietary trading indirectly by investing in (or sponsoring) certain hedge funds and private equity funds.

Federal banking and securities regulators issued regulations broadly implementing the Volcker Rule to prohibit any bank proprietary trading and investment activities regardless of their value to bank or customers, rather than specifically defining and prohibiting the trading and investment activities that were the object of the systemic worries that led to the Volcker Rule. As a result, many of the regulations' requirements beg the question as to why are they applied to the activity to be regulated, providing little operational clarity or policy direction on compliance requirements. This is especially so for the "permitted" activities under the regulations, which can be likened to precariously situated islands of permission in an ill-defined and turbulent and foggy sea of prohibition.

Regulators finalized these broad regulations even though it had been documented at the time that the activities prohibited in the Volcker Rule did not cause the financial crisis, a realization that has been reinforced with time. Specifically, a 2011 Government Accountability Office (GAO) report confirmed that neither proprietary trading nor investments in hedge or private equity funds by banks were a proximate cause of the financial crisis of 2008.[2] The GAO report further stated that "FDIC staff, whose organization oversees bank failures, said they were not aware of any bank failures that had resulted from standalone proprietary trading."[3] More recently, a 2016 Federal Reserve-commissioned report concludes that the Volcker Rule may have an adverse impact on liquidity in the corporate bond market.[4]

Rather than solving problems, the Volcker Rule has created problems. It has operated to impede the efficient operation of the financial system, drive banks away from providing services valued by their customers, reduce competition in affected markets, and overall act as a drag on the economy. At the same time, it has heavily involved five financial regulatory agencies in a confused and unproductive exercise to administer the new rules.

I. Harm to the Economy and Banks' Ability to Serve Customers

Although the Volcker Rule was intended to apply only to excessively risky proprietary trading done directly or through investment funds, the regulations require that *every* banking entity's compliance policies and procedures "include measures that are designed to prevent" the bank from becoming engaged in Volcker Rule-prohibited activity. Because the regulation treats any proprietary activity as prohibited unless it fits into narrow exceptions, *every* bank and every affiliate, regardless of its size or activities, must read and understand the Volcker Rule regulations in order to review all of its investment activities to determine which activities fit into the narrow exceptions. This has been a complex, and at times, fruitless exercise for nearly all banks. This is compounded by the problem that it is often not readily apparent under the regulations what is permissible versus impermissible trading and investment activity, much being left to regulatory judgment and the even more serious problem of variant interpretations among the several agencies by which a bank is supervised.

Indeed, in many cases, a bank may not know whether it is engaged in impermissible activities until it is notified in the course of a bank examination. In other words, a bank may be required to undertake an initial *and ongoing* careful legal analysis to determine which trades and

[2] See GAO Report, "Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented" (July 2011).
[3] *Id*. at 26.
[4] See Jack Bao, Maureen O'Hara, and Alex Zhou (2016). "The Volcker Rule and Market-Making in Times of Stress," Finance and Economics Discussion Series 2016-102. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2016.102.

investments will, or might, fall within the constraints of the Volcker Rule regulations, and still not know with an operational degree of certainty whether its activities are outside the scope of the regulations or in compliance with them. This makes bank compliance efforts costly, risk-averse, and allocation of financial resources suboptimal.

Lasting damage to bank *customers* and to the economy overall results from this misallocation of financial resources and regulator and banker attention. Not only are banks and regulators involved in compliance exercises of uncertain value, but investment opportunities are hindered that, despite posing none of the risks that are the object of the Volcker Rule, banks relinquish because of the overbroad and uncertain scope of the regulations.

Since banking organizations have stopped conducting the proprietary trading that was the object of the Volcker Rule, the Rule's general assumption that activity is prohibited has produced an upside down exercise by banks of demonstrating an activity to be permissible. To ensure compliance, banks often constrain their activity to a greater degree than is required under a conservative interpretation of the regulations, thereby giving up more opportunities for economic activity that could benefit customers and communities.

The following are a few examples illustrative of many foregone business prospects and opportunities to serve bank customers and communities:

- Banks have had to shutter credit operations that supported the venture capital funds, stifling investment in start-up and emerging growth companies that create an average of three million jobs each year.
- Banks serving as custodians for customers have had to shift custody to outside providers as a result of the Volcker Rule's "Super 23A" provisions. Segregating fund functions and operations with third parties has disrupted customer relationships and increased operational risk and inefficiencies solely because of the potential for intraday or overnight overdrafts which the Volcker Rule prohibits.
- Banks have had to decline new business from wealth management customers, particularly family office relationships, out of concern that certain pooled investment vehicles consisting of two or more unrelated families fall within the definition of "covered fund."
- Banks have had to curtail their lawful market-making and foreign exchange activities due to concerns about possibly tripping the line on proprietary trading.
- Banks have eschewed purchasing for asset liability management purposes available-for-sale securities that are close to maturity, or purchasing short-term securities, in order to avoid tripping the Rule's 60-day presumption associated with short-term trading.
- Banks are compelled to avoid making even minor ministerial adjustments on derivatives hedging their long-term debt securities, since that may trigger Volcker trading account status under the 60-day presumption.

We note that banks already are subject to regular supervision and examination via the full panoply of regulations and interpretive guidance related to trading and investment fund activities. These *existing* regulatory tools should be leveraged (rather than doubled) in order to assist both banks and the federal bank regulatory agencies to monitor activities that might stray into activities subject to the Volcker Rule. We recognize that there are risks with all financial activities. A targeted supervisory approach would better address the regulation and management of the risks chosen for Volcker Rule attention, through which agency oversight could be specifically applied, with excessive risks addressed and corrected.

II. Specific Recommendations

A. Repeal the Volcker Rule; In the Meantime, Mitigate the Harm

The Volcker Rule should be repealed in its entirety. Proprietary trading and investment activity did not cause the financial crisis of 2008, and a ban on these activities does not promote banking safety and soundness. Indeed, by reducing diversification in banks and decreasing the field of participants in financial markets, the Volcker Rule increases risk. Until such repeal is enacted, the federal financial regulatory agencies should mitigate the Rule's adverse effects on the economy and on bank customers by substantially amending the Volcker Rule regulations so that they are consistent with vibrant financial markets, tailored regulation, and with sound banking practices.

B. Change Focus to What is Prohibited

Agencies should amend the Volcker Rule regulations and their rulemaking approach by focusing on what constitutes *prohibited activities*, allowing banks to avoid those activities and return their attention from a quest for "permitted" activities to identifying how best to serve customers. This would also make Volcker Rule regulation and supervision more consistent across the federal financial agencies and require fewer neo-quixotic efforts to find a five-agency consensus on what might be permissible.

Implementing this approach to Volcker Rule regulation does not require statutory change. It could be accomplished by action of the regulators, involving redefinition of key terms, such as "proprietary trading," "hedge fund," and "private equity fund." The goal should be to provide certainty that the rules will not impede banks from engaging in *bona fide* market-making, asset liability management, hedging, and other trading activities, or from having relationships with ordinary corporate vehicles and other fund entities that are not those funds that the Volcker Rule is intended to regulate. This would permit banks to continue responsibly managing their non-banned trading and investment activities with the necessary degree of certainty and with a minimum of disruption to the routine banking operations on which banking customers have come to rely.

C. Tailor the Applicability

The prohibitions of the Volcker Rule should be applied exclusively in relation to systemic risk (whether in institutions, products, or practices), and vary in application directly according to the risks. Any amendments to the scope of the Volcker rule should apply uniformly to banks and their affiliates.

D. Principal Activity Should Be Presumed Permissible.

Market participants would benefit from a more straightforward way of demonstrating that they are not engaged in prohibited proprietary trading. The Rule should be refined with a clear focus on the activity sought to be prohibited, so that banks do not have to defend permissible and economically useful hedging (for themselves and customers), asset-liability management, and market making for customers. This could be accomplished through reconsideration and removal or refinement of unnecessarily opaque and restrictive provisions in the regulation.

E. Simplify Fund Investment Prohibitions

Prohibitions regarding investment funds should be more tailored and targeted. For example, the Volcker Rule regulations should apply only to those hedge funds and private equity funds that engage primarily in proprietary trading for near-term investment gains, thereby excluding funds (such as venture capital funds) or activities (such as seeding investment strategies) that do not raise the risks the Volcker Rule is intended to address.

F. Streamline the “Super 23A” Provisions

The so-called “Super 23A” provisions governing bank relationships with affiliated investment funds unnecessarily prohibit many routine business and credit-related transactions. These provisions should be amended to permit transactions between the banking entity and investment fund that are consistent with existing affiliate transaction rules.

G. Improve Interagency Coordination.

The Treasury Department should take the lead to encourage interagency coordination on the application and interpretation of the Volcker Rule. The key administrative principle should be that one agency should be designated to examine the entire firm for Volcker Rule compliance (which could be based on which prudential regulator regulates the dominant legal entity in the banking or financial organization). Moreover, there should be one agency responsible for issuing interpretive and enforcement guidance, including common examination policies and procedures. This arrangement can be established by memoranda of understanding, facilitated by the Treasury Secretary’s good offices, which can also be drawn upon to address questions of coordination.