Insight

The 5-5-5s of Dodd-Frank at 5: Episode 3

MEGHAN MILLOY | JULY 15, 2015

The Problem: The Volcker Rule

Mandated by Dodd-Frank, the Volker Rule was adopted in 2013 by the Commodity Futures Trading Commission (CFTC), the Office of the Comptroller of the Currency (OCC), the Securities and Exchange Commission (SEC) and the Federal Reserve (Fed). At its heart, it prohibits banks from engaging in proprietary trading and subjects those banks that do trade to enhanced prudential monitoring by the Fed. It also limits banks' ownership in hedge and private equity funds. Proponents of the rule argued that those sorts of activities were overly speculative, added unnecessary risk to the industry, and ultimately caused the financial crisis. That's simply not the case.

Jeb Hensarling, Chairman of the House Committee on Financial Services aptly described the Volcker Rule as "a solution in search of a problem." As former Treasury Secretary Timothy Geithner noted in his dissenting opinion regarding adoption of the Volcker Rule: "If you look at the crisis, most of the losses that were material for the weak institutions – and the strong, relative to capital – did not come from those [proprietary trading] activities. They came overwhelmingly from what I think you can describe as classic extensions of credit." Several experts agree that proprietary trading was not the cause of the crisis, and, since the Volcker Rule therefore fails to address the cause of the crisis, it amounts to nothing more than another needless regulatory burden on the American financial sector.

The Repercussion: Diminished Liquidity, Access to Credit

The Volcker Rule doesn't fully take effect until July 21, 2015, but, already, the length (nearly 1,000 pages) and complexity of the Volcker Rule have generated millions of dollars in compliance costs to be passed along to consumers and caused a sharp reduction of liquidity in bonds and other securities. Banks traditionally "make market" in various securities by buying, selling, and holding inventories. While this provides a way to make sure that markets are liquid, it also can run afoul of the Volcker Rule.

As banks are forced to shed their market-making operations, consumers lose their ability to trade quickly and at a steady price. Furthermore, now that banks have higher capital requirements, they're not taking up any excess space holding inventories of assets awaiting a buyer. JPMorgan carried $2.7 trillion in corporate bonds in 2007, this year that number is down to $1.7 trillion and falling. That lack of liquidity hurts consumers directly, as their options for financial products and services are limited, and indirectly, as less liquid U.S. banks lose their competitiveness – Europe and much of the rest of the world are not restricted by bans on proprietary trading, etc. It also should come as no surprise to regulators that the banning of proprietary trading will only drive those activities into less regulated or even unregulated areas of the financial system, thereby undermining their entire purpose for the Rule.

Additionally, it is well documented that as liquidity decreases, the cost of capital for businesses increases. A 2006 Amihud and Mendelson study shows that the level of liquidity (which the study measures as the bid-ask spread on a sample set of stocks) affects the anticipated return on those stocks and thus the firm's resulting cost of capital. There is a positive relationship between stocks' excess monthly returns and bid-ask spreads for any given level of systematic risk. Thus, average returns are higher for stocks with higher bid-ask spreads, and the increase in the bid-ask spread as a result of the Volcker Rule will result in higher capital costs for those businesses. The resulting increased capital costs means slower economic growth and reduced job creation which isn't good for anyone.

The Fix: Allow for Proper Risk

All financial activities entail risk, but any financial activity is only as risky as the rigor and effectiveness of the risk management and control apparatus around that activity. Putting 300 people into an aluminum tube and shooting them 600 miles per hour through the air seven miles in the sky sounds insanely risky, but air travel is statistically the safest means of getting around due to a robust safety and control framework.

Rather than arbitrarily prohibiting perfectly legitimate financial activities, a better and more appropriate role for government is to work with the financial services industry to improve the rigor and quality of risk management, internal controls, corporate governance, capitalization, and official supervision to ensure that financial risk is prudently taken, properly controlled, and well-managed.