Insight

Volcker Rule a Costly Way to Solve a Non-Problem

SAM BATKINS | DECEMBER 10, 2013

Today five financial regulatory agencies offered the final version of the so-called “Volcker rule,” as mandated by the Dodd-Frank Act. The Volcker Rule is intended to circumscribe allowable activities by financial institutions that benefit directly (or linked to entities that benefit) from deposit insurance and other government protections.

ANALYSIS OF THE RULE

The rule offers a highly complicated and specific set of guidelines which determine the allowable set of trading activities.

Of note, the following are exempt from the rule:

- Trading in U.S. government, agency and municipal obligations;
- Underwriting and market making-related activities;
- Risk-mitigating hedging activities;
- Trading on behalf of customers;
- Trading for the general account of insurance companies; and
- Foreign trading by non-U.S. banking entities

Also of note is that “risk-mitigation” activities will need to be done in an aggregate sense (which is narrower than “portfolio hedging,” seen by various people to mean a larger set of activities). Additionally, the hedge has to be identified at inception of the trade. There is much talk about “specificity” even though it must apply in the aggregate which will be a difficult needle to thread.

During the Federal Reserve discussion of the rule, Chairman Bernanke asked, “How perfect of a hedge do you need?” This of course raises the question of how complicated a compliance structure would entities need to create, or would they just abandon most of the covered activity (many already have). Companies must demonstrably reduce the risk of another position the entity has in their portfolio. The rule doesn't require perfect hedging, but it does spend roughly 1,000 pages to determine what is legally acceptable.

SUPERVISORY ROLE

Regardless of the quality of the rule, this puts an enormous burden on the supervision regime. The supervision role of the Fed is an important piece of their micro- and-macroprudential regulation. Observers should have concerns about how examiners/analysts from other agencies will be able to adopt and adequately apply such a complicated and unclear rule (on top of the many other rules they are meant to be simultaneously

knowledgeable and competent on). As Governor Raskin pointed out, "examiners will need guidance." That is an understatement. She also admits that application of the role through supervision regimes may vary according to which agency is in question.

REGULATORY COMPLIANCE BURDEN

Relative to the initial proposed rule, the paperwork burden is significantly reduced, but not because the final rule is more lenient. The final rule merely assumes fewer respondents, as entities with less than $50 billion (eventually $10 billion) in assets are largely exempt.

The initial proposal estimated 6,583,844 hours, and the final rule revised this to 2,376,272, still a significant figure, as it is applies only to a handful of larger entities. This is now the fifth most burdensome Dodd-Frank rule by hours, but probably the most profound from a qualitative perspective.

The rule's analysis doesn't monetize this figure, but they do admit the final rule will impose at least $100 million in annual private-sector mandates (outside estimates range from $2 billion to $10 billion annually). This is a reversal from their earlier analysis.

"The OCC previously determined that the proposed rule would not impose any Federal mandates resulting in expenditures by State, local, and tribal governments, in the aggregate, or by the private sector of $100 million or more…. The OCC has determined that the final rule qualifies as a significant regulatory action under the UMRA because its Federal mandates may result in expenditures by the private sector in excess of $100 million"

SMALL BUSINESS IMPACT

The rule does not anticipate any impact on small entities. Only banking entities with assets greater than $50 billion will need to develop an enhanced compliance program.

Additionally, state and local authorities like state utility commissions, and pension funds such as TIAA-CREF warn about the impact of the rule on increasing electricity costs and reducing retirement fund returns, respectively.

CONCLUSION

Finalization of the "Volcker Rule" was done pursuant to Title VI of the Dodd-Frank Act, but Congress should nonetheless be wary about its effects. Proprietary trading (the primary aim of the rule) was not a cause or major contributor to the recent financial crisis. Even recent major losses owing to such trading (JP Morgan's "London Whale" trade) have not put the financial system at any risk of major disruption. Even if limiting participation in such trading activity were advisable, regulators should be concerned about the ability of their supervisory and examination apparatus to thread the needle between allowed and disallowed trades.