Insight

‚ÄúVolcker Rule‚Äù is the Wrong Response to the Financial Crisis

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“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.”

– Treasury Timothy Secretary Geithner, Sept. 10, 2009

On January 21st, President Obama announced a proposal that would ban commercial banking companies from engaging in proprietary trading, hedge fund, or private equity activities. The President called the proposal the “Volcker rule,” after former Federal Reserve Chairman Paul Volcker, who had been advocating such a ban for months. More recently, Senator Blanche Lincoln (D-AR), Chairman of the Senate Agriculture Committee, successfully passed out of her Committee legislation that would require banking companies to divest of their derivatives trading businesses. The Lincoln provision was included in the Senate’s regulatory reform bill – “The Restoring American Financial Stability Act” – which passed the Senate last Thursday evening by a vote of 59 to 39.

In comments before a conference at the Mayflower Hotel in Washington yesterday morning, House Financial Services Committee Chairman Barney Frank (D-MA), the appointed Chairman of the upcoming conference committee charged with reconciling the House and Senate financial reform bills, said Senator Lincoln’s derivatives desk spin-off proposal “goes too far.” Strongly suggesting that imposition of Volcker rule restrictions would be the price for dropping the Lincoln proposal, Congressman Frank stated: “I don’t see the need for a separate rule regarding derivatives because the restriction on banks engaging in proprietary activities would apply to derivatives as well as everything else.”

A proper policy response to the recent financial crisis depends on an accurate diagnosis of the factors that actually contributed to it. Trading – proprietary or otherwise – did not cause the financial crisis. The Volcker rule and the Lincoln proposal that would ban banking companies from dealing in derivatives misdiagnose the causes of the crisis and would needlessly undermine the effectiveness and international competitiveness of U.S. financial institutions, to the detriment of American businesses, consumers, savers, and investors.

Trading Didn’t Cause the Financial Crisis

- The financial crisis was not a “risky trading” crisis – it was a poor lending crisis. The value of mortgage-backed securities plummeted in value not because they were traded, but because too many of the mortgages that backed those securities fell into foreclosure. Policymakers should focus on fixing why that happened.
- At a September 10th, 2009 hearing before the Congressional Oversight Panel, Treasury Secretary Timothy Geithner stated in response to a question about the role of proprietary trading in causing the financial 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 fairly describe as classic extensions of credit."

- In an October 2009 report "Deregulation and the Financial Crisis," Peter Wallison of the American Enterprise Institute, concluded that "there is strong evidence that, despite heavy regulation, many of the banks that got into trouble did so by failing to act prudently in their investment or lending activities – in other words, in their capacity as banks – and not because they engaged in securities trading or were affiliated with investment banks that were underwriting and dealing in securities."

"Plain Vanilla" Lending is a Risky Activity

- Senators Blanche Lincoln, John McCain, Maria Cantwell and others have talked about protecting "plain vanilla lending" from "risky trading," as if lending is lower risk or even riskless. Not only does lending entail risk, lending – money out the door that banks hope will be paid back – is arguably the riskiest activity that any financial entity can engage in.

- Virtually every financial crisis in history – including the recent crisis – has been lending-related crises.

- 140 banks failed in the United States last year, the highest rate of failure since 1992. Another 72 banks have failed so far this year, an even faster pace of failure than last year. Each of the 212 banks that have failed since January of 2009 failed because of loan losses – not one because of trading.

Diversification of Revenues Help Make Banks More Stable

- Institutions that had a diverse mix of businesses – commercial banking, securities underwriting, and trading – performed best during the recent crisis. JPMorgan Chase, Wells Fargo, and Bank of America served as the instrumentality of stability and recovery during the crisis by absorbing other failing institutions. JPMorgan Chase absorbed Bear Stearns and Washington Mutual; Wells Fargo absorbed Wachovia; Bank of America absorbed Countrywide and Merrill Lynch.

- Trading activities don't necessarily make banks more risky; in fact, they can help make banks less risky and more stable by diversifying the company's activities and revenue streams.

Trading Restrictions Would Undermine Competitiveness of U.S. Institutions

- In February, European finance ministers indicated that Volcker rule restrictions would violate European Union universal banking laws. Because Europe and much of the rest of the world are unlikely to ban banking companies from proprietary trading, hedge fund, and private equity activities, imposing the ban on U.S. institutions would amount to unilateral disarmament.

- Large corporate clients who depend on U.S. banks' ability to provide the full range of financial products and services – loans, underwriting, trading, private equity, asset management, etc. – would likely turn to non-U.S. institutions if Congress bans banks from providing such services.

- At a February 2, 2010 hearing of the Senate Banking Committee, Chairman Chris Dodd (D-CT) stated: "For us to adopt this rule without the rest of the international community…that makes this unworkable."

- Undermining the competitive position and, therefore, the profitability of U.S. financial institutions will likely raise the cost of capital to American businesses, consumers, and homebuyers, slowing economic growth and job creation.

Banning Banks' Trading Activities Undermines the Principal Objective of Reform

- Because there is a robust market for the trading and market-making services provided by large banking companies – which are heavily regulated – banning banking companies from trading, hedge fund, and private equity activity will only drive such activities into less or even unregulated aspects of the financial system, increasing systemic risk and undermining the fundamental objective of regulatory reform.

- FDIC Chairman Shelia Bair made this point in an April 30th letter to Senate Banking Committee Chairman Chris Dodd (D-CT) and Senate Agriculture Committee Chairman Lincoln. Federal Reserve Chairman Ben Bernanke made the same argument in a May 12th letter to Senator Dodd.

All financial activities entail risk, but any financial activity – lending, trading, underwriting, insurance, asset management, etc. – 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 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.