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By Douglas J. Elliott[1] and Christian Rauch[2]

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Introduction

In December 2013, the five major bank and capital market regulatory agencies in the U.S.[3] adopted the final set of rules to implement Section 619 of the Dodd-Frank Act, commonly known as the "Volcker Rule". The major goal of the Rule is to ban proprietary trading activities in banks. "Proprietary Trading" is defined as any short-term trading activity (usually for a holding period of less than 60 days) which is not performed on behalf of a client and is funded by the bank's own money. In addition, banks are forbidden to hold more than minor stakes in hedge funds and private equity and venture capital funds.

Those in favor of the Rule argue that it will decrease systemic risk, by reducing excessive risk taking at the banks and their affiliates. In addition to the direct effects, banning proprietary trading, and traders, from banks is asserted to shift their cultures towards a more conservative and client-focused business model for banking. The introduction of similar regulatory proposals in the wake of Volcker outside the U.S., most notably the European Commission's proposal on banking structural reform, and the Vickers Commission proposal in the U.K., lend further political and economic support to the Rule.

However, critics of the Rule warn that financial markets will become substantially less liquid and that the cost of transactions will rise significantly, reducing the value of existing securities and making it more expensive for companies and others to raise funds in the future. These problems are amplified by the vagueness of the term "proprietary trading". With the exception of trading executed by banks as a fiduciary, all trades are for the bank's own account and thus could be viewed as proprietary. Therefore, the Volcker Rule has found it necessary to exclude categories of trades that are perceived

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[3] The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission.

as ultimately being for the benefit of clients. This is much harder than it would appear, which explains the difficulty of finalizing the regulations and the complexity of the final version. Critics argue that banks will shy away from many trades that are ultimately for the benefit of their clients because of the difficulty of ensuring they will meet the rules. Banks underwrite securities, make markets, manage liquidity, and hedge. Separating the wanted from the unwanted trades is difficult and the risk of causing unwanted market frictions through a flawed implementation might be high.

Banks started to react to the Rule as early as 2011. So called “bright line” proprietary trading desks were closed and the employed traders were either laid off or relocated to other departments in the banks. Also, hedge fund and private equity and venture capital business was ended and the funds were sold off. However, in spite of these initial reactions, the real effects of the Rule remain to be seen and are still highly contested. This opacity surrounding the Rule is troubling. As briefly explained above, its potential effects will stretch beyond banks to capital markets and the real economy. Also, the other mentioned regulatory frameworks (European Commission, Vickers) all go in a similar direction to Volcker. The better Volcker and its consequences are understood, the better will be the design of the subsequent regulations. A detailed understanding of the Rule is therefore pivotal.

It is the goal of this note to help clarify the Volcker Rule and explain its possible consequences. A special focal point will be to discuss whether or not the benefits will outweigh the costs of the Rule. We discuss five pressing questions surrounding the Volcker Rule. To answer these questions, we combine a multitude of different opinions about the Rule, ranging from economic research results to legal scholars’ opinions, and industry reports.

1st question: What was the origin and initial goal of the Rule?

The Volcker Rule was introduced initially as an answer to the recent financial crisis in the U.S. as well as the massive adverse implications it had for the economy as a whole and the banking sector in particular. In February 2009, President Obama chose Paul Volcker to support his Administration in its efforts to prevent future financial crises. From the start, one of Volcker’s arguments was that a source of instability was the trading-oriented business model of modern banks. He argued that government guarantees and central bank intervention lead to moral hazard in banks. To curb excessive risk-taking behavior of banks, proprietary trading would need to be banned. Volcker acknowledged that trading is an important part of modern capital markets; however, he stated that it does not necessarily have to be linked to other commercial bank activities, such as lending or deposit taking, which are more vital to the functioning of an economy. Consequently, in his proposal, Volcker argued that banks should be prohibited from engaging in proprietary trading and from investing in hedge fund and private equity business. According to Volcker, these activities are neither necessary nor closely linked to core banking activities and could therefore be abolished easily, especially given their high-risk nature. An adjusted and more detailed version of this original proposal was finally signed into law as Section 619 of the Dodd-Frank Act in 2010.

Following the passage of the Act in 2010, the final implementation of the Rule took more than three years. The five main regulatory bodies were tasked to come up with a detailed implementation plan of the Rule by August 2012. This deadline was missed by over a full year. The final version of the Rule was presented in December 2013. The Rule will become effective on April 1, 2014 and the conformance period, during which penalties for violations are non-existent or light, will end on July 21, 2015. Starting in June 2014, the largest banks with asset holdings exceeding 50 billion U.S. Dollars will have to report quantitative measures of their proprietary positions and their general compliance to their supervisors. Smaller banks are exempted from requirements until 2016, when the Rule is expected to be fully implemented.

2nd question: What exactly does the final Rule say?

The general goal of the Rule is to prohibit banks from engaging in so called proprietary securities trading. The term "proprietary" refers to trading activities which are not performed on behalf of a client and are funded by the bank's own money. Prior to the recent financial crisis, banks would perform proprietary trading to take on speculative positions in various securities markets to bet on movements in these markets. Since the trading positions were made with the banks' own money, the full risks and rewards of these speculations were borne by the banks. Generally, proprietary trades could be made either by designated "Prop Desks", that is, departments within the bank which would solely engage in proprietary trading, or by single traders who would perform other trading-related business for the banks, such as, for instance, market making or underwriting activities. Also, many banks were running their own in-house investment funds which performed proprietary trading activities, such as hedge funds or, for longer-term speculative investments in non-listed stock, private equity funds.

To ban these activities, the Volcker Rule prohibits proprietary securities trading per se, as well as the running or ownership of hedge and private equity investment funds. Although the final Rule is a complex and lengthy combination of prohibitions and exemptions, the general structure of the Rule is rather simple: in a first step, the Rule lists and defines all activities which are generally restricted. In a second step, the Rule introduces a specific set of "catch-all" clauses to also put a ban on activities which were not adequately defined or perhaps missed in the first step of the Rule. It can be thought of as a closing-of-loopholes section. In a third step, the Rule introduces a set of exemptions from the banned activities to allow banks some desired trading activities which might otherwise be banned by the Rule. And in a fourth and final step, the Rule contains guidelines banks have to follow to document their compliance with the Rule.

The first step: general prohibitions

In a first step, the Rule generally prohibits any kind of proprietary trading activities in banking entities, either performed by the bank directly or through banks' in-house investment funds. The Rule therefore prohibits banks from owning or running those kinds of investment funds which are defined by the Investment Company Act of 1940 as "investment companies" (typically hedge funds and private equity funds). Purchases and sales of securities are deemed proprietary trading if the bank performs these activities not on behalf of a client as broker, agent, custodian or service provider for an unaffiliated third party. The term "banking entity" refers to any kind of insured depository institution and bank holding company, as well as to all holders, controlling entities or subsidiaries of such institutions.

The second step: the catch-all rules

The Rule states that, unless otherwise permitted, banks have to refrain from all kinds of "high-risk asset trading" or trading which might incur a "material conflict of interest" for the bank or its traders. Also, any kind of short-term trading activities are prohibited in which the bank solely acts on its own account and purchases and resells securities within 60 days or less. Finally, a bank must design its compensation schemes in a way that proprietary risk-taking in trading activities is not financially rewarding to the traders. In other words: even if a trader were to engage in any kind of illegal proprietary trading activities, she is not allowed to participate in any returns made from this trade.

The third step: the exemptions

The Rule provides exemptions for proprietary trading activities in connection with securities underwriting, market-making, hedging, trading in government securities, repos, clearing, liquidity management, and trading activities as part of a designated deferred compensation scheme or pension plan. Trading these instruments or performing economically useful market operations such as underwriting or market-making which require the bank to hold proprietary positions in securities is clearly desired by the regulatory authorities and therefore exempted from the prohibitions. However, these exemptions cause the biggest implementation issues of the Volcker Rule. Government securities, repos, clearing, and securities held in compensation plans are straightforward and easily distinguishable from prohibited proprietary trading. However, banks engaging in underwriting and market-making activities might easily speculate on market movements by building up proprietary securities positions which go beyond the position sizes needed for market-making or in connection with underwriting business. The same applies to hedging transactions. To distinguish illegal proprietary trading from desired underwriting and market-making, the final Rule implementation states that banks may only hold securities positions for underwriting or market-making purposes which reflect the reasonably expected market demand for said security in the near-term future. Any proprietary position sizes which go beyond this demand are deemed illegal. For hedging, the bank must document which exact positions are hedged with any proprietary securities position.

Finally, there are two de minimis rules in place to allow banks restricted investments in otherwise prohibited investment funds. First, banks are permitted to own a maximum of 3% of a fund's outstanding ownership interests. Second, a bank's total invested volume in prohibited investment funds' ownership rights must not exceed 3% of its total Tier-1 capital.

The fourth step: compliance

The compliance rules vary in accordance with bank size and are strictest for the largest banks and those with significant trading operations. Those banks affected the most have to set up detailed compliance plans to document the exact position and purpose of any trading-related activities. The compensation schemes of the employed traders are also to be documented.

3rd question: What are the perceived benefits of the Rule?

There are five major benefits the implementation of the Volcker Rule is believed to have, for banks and the overall economy, according to supporters.

First and foremost, prohibiting proprietary trading activities from banks is believed to make single institutions and the banking system safer as a whole. It shields banks from market risks and high earnings volatility, and reduces the risk of systemic failure from common shocks or contagion.[4] Banks will also be smaller, which, all else equal, further reduces systemic risk. Research on the interconnectedness of different banking activities suggests that lower trading risk exposure also has a beneficial risk-mitigating effect on "classic" bank activities such as lending.[5] Third, prohibiting banks from private equity and hedge fund activities directly addresses one source of bank default risk. One

[4] See Brunnermeier, Dong and Palia (2013).
[5] See Boot and Ratnovsky (2012).

study of causes of bank failures during the recent crisis concludes that private equity and venture capital activities contributed significantly to banks' probability of default.[6]

Fourth, another factor contributing indirectly to future bank stability is an increased transparency and lower risk of fraud through the heightened compliance standards of the Volcker Rule. As explained above, the Rule calls for a very detailed compliance plan in which the bank has to list securities positions and the reasons for holding them. It also has to be documented that compensation schemes of traders are not linked to revenues or income from proprietary positions. The fact alone that a bank has to actively demonstrate transparency in its securities-related business is assumed to deter fraud. Recent illegal trading-related activities, such as the cases of Jérôme Kerviel of Société Générale and Kweku Adoboli of UBS might therefore be prevented in the future. Also, clients are no longer potential counterparties in banks' proprietary trades. Cases in which clients are defrauded as part of proprietary securities deals, like the recent scandal involving Goldman Sachs trader Fabrice Tourre, may therefore to be avoided as well. Of course, most frauds of size involve the perpetrators lying to their own management, so it is unlikely that these documentation requirements will completely eliminate frauds of this nature.

On a more general note, many supporters of the Rule also cite a "cultural change" argument. Although rather intangible in nature, the argument states that in the absence of proprietary trading, banks may drift towards a more risk-averse business culture. "High octane" prop-traders are laid off or relocated to other departments, hence losing their perhaps negative influence on other employees' risk-taking behavior. The overall approach of the bank to do business is therefore likely to become more conservative.

4th question: What are the perceived costs of the Rule?

There are four major problems associated with the implementation of the Volcker Rule, each believed to impose direct or indirect costs on banks and the economy as a whole.

First, banks are believed likely to retreat from market making activities. Banks face implementation costs to prove they do not hold securities positions beyond the near-term market demand, with penalties if the supervisors do not agree, judging in retrospect. Also, they will be unable to reap profits through speculative positions as part of their market making business. Both effects can make an otherwise attractive business unprofitable, causing banks to give it up or drastically reduce their activities therein. This will lead to lower market liquidity, causing higher transaction costs, mispricing

[6] See DeYoung and Torna (2013).

and higher risk premia which result in higher costs of capital for corporations. Market volatility will most likely increase as well. By retreating from market making, banks cannot soften sudden supply and demand shocks in securities markets through their inventory.[7] These effects could be avoided if non-bank market making service providers fill the gap in the market. However, these entities may not have the size and stability to fully offset the banks' retreat and may be substantially less regulated.[8] Further, a rapid transition in this direction may encourage such firms to ramp up their activities before developing the necessary risk management culture.

Second, banks will become less diversified and profitable. Although highly volatile, trading business represented a major fraction of banks' overall income with a low correlation to other revenue and income streams of the bank. Lower profitability and higher correlation of a bank's businesses can make the bank less stable. In addition to lower profitability, banks will also face higher permanent costs through the compliance requirements of the Volcker Rule. Initial estimates of Standard & Poor's see a 10 billion U.S.-Dollar decrease in pretax earnings per year for the eight largest U.S. banks.[9] In a worst case scenario, Standard & Poor's hinted at a ratings downgrade these effects might lead to, imposing even higher costs on banks through increased refinancing rates.

A third major potential problem with the Rule is that even though it eliminates proprietary trading activities from banks, it does not shield them from exposure to risks emanating from these activities. In a modern financial market, banks rely on other market participants to perform services for them. Prime examples are hedge funds which purchase credit risk exposure from banks and manage it for them. A ban on proprietary trading in banks will not make it cease to exist, but rather move it to other financial market participants, which are most likely less regulated – such as hedge funds. By doing business with them and operating in the same markets as them, banks still face the risk of being adversely affected by trading risks.[10] Since proprietary trading in hedge funds is less regulated than it is in banks, these risks are likely to be higher.

The fourth major problem with the Rule is that it does not directly address a major reason for bank failure during the recent financial crisis: credit risk. The great majority of bank defaults was caused by "classic" credit risk, such as loan defaults, or a combination of asset price shocks (through loan defaults) and illiquidity.[11] Prohibiting proprietary trading does not solve these problems in banks. Although the Volcker Rule does not aim at addressing credit risk, the systemic risk component of a

[7] See Thakor (2012).
[8] See Duffie (2012).
[9] See Standard & Poor's (2012).
[10] See Whitehead (2011).
[11] See Cole and White (2012).

common shock or contagion through sudden asset price shocks is still prevalent and can hit banks even without being exposed to trading portfolios.

5th question: how have banks and markets reacted so far?

U.S. banks first started to react to the Rule in 2010/2011 by disposing of their in-house investment fund business and "bright-line" proprietary trading desks (trading desks specifically designed for and designated as proprietary trading business). Among the large banks, J.P. Morgan Chase was the first to announce the end of their prop trading desks in September 2010. Goldman Sachs (in March 2011) and Citi (January 2012) followed soon thereafter. The in-house investment fund businesses were either closed or sold-off to private equity or hedge funds. Most notably, Citigroup and Bank of America sold their respective 1.7 and 1.9 billion USD private equity portfolios to AXA Private Equity in 2011. Although the Rule initially only affected U.S. banks, other international banks quickly followed suit and ended their in-house fund business as well. Examples are U.K.-based Barclays, French Crédit Agricole, or Deutsche Bank, all selling their fund portfolios in 2011.

The European banks' reactions were to a large degree also driven by the intent of various European bank regulatory authorities to implement frameworks similar to Volcker. In September 2011, the Vickers Commission was the first to present a proposal for future banking regulation in the U.K., containing many provision closely related to Volcker. The core of the proposal is to separate banking entities with and without securities business. The goal is to "ring-fence" retail banks with deposit and (SME-) lending business from the risks of trading-related business. In January 2014, the European Commission published its proposal for a similar regulatory framework in the European Union. The proposal includes a Volcker-like provision which prohibits large, systemically relevant financial institutions from engaging in proprietary trading or hedge fund-related business. Once signed into law, the Commission's proposal will be binding for all of Europe. Additionally, some single-member countries have implemented related laws of their own. One example is Germany which put the "Trennbankengesetzt" (law of banking separation) in place in May 2013. This, too, puts a ban on proprietary trading. So far, the Volcker Rule therefore has had wide-ranging implications, not only for the affected banks directly, but also for bank regulators and lawmakers in other jurisdictions.

Conclusions

Although the Volcker Rule reacts to real risks and problems that became evident in the Global Financial Crisis, it does not meet basic tests of clarity, feasibility, and cost-benefit analysis, in our view. "Proprietary Trading" is an inherently vague concept that overlaps much too strongly with genuinely economically useful activities such as market-making. As a result, it has proven exceedingly difficult to implement and is very likely to do more harm than good. Further, the purported risk-reduction benefits are quite speculative.

Hopefully, European policymakers will adopt an approach that focuses on genuine risk reduction without attempting to do the impossible by differentiating "proprietary trades" from socially useful activities. One way to do this would be to confine the definition of proprietary trades to categories that are quite clearly on that side of a bright line, although this will leave supporters dissatisfied, since it is likely to eliminate a relatively small amount of activity. Another approach, with greater intellectual rigor, is to require substantially higher capital for trading activities that appear to carry the potential of excessive risk. Measuring risk and comparing it to a bank's ability to absorb losses is a superior way of focusing on excessive risk.

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