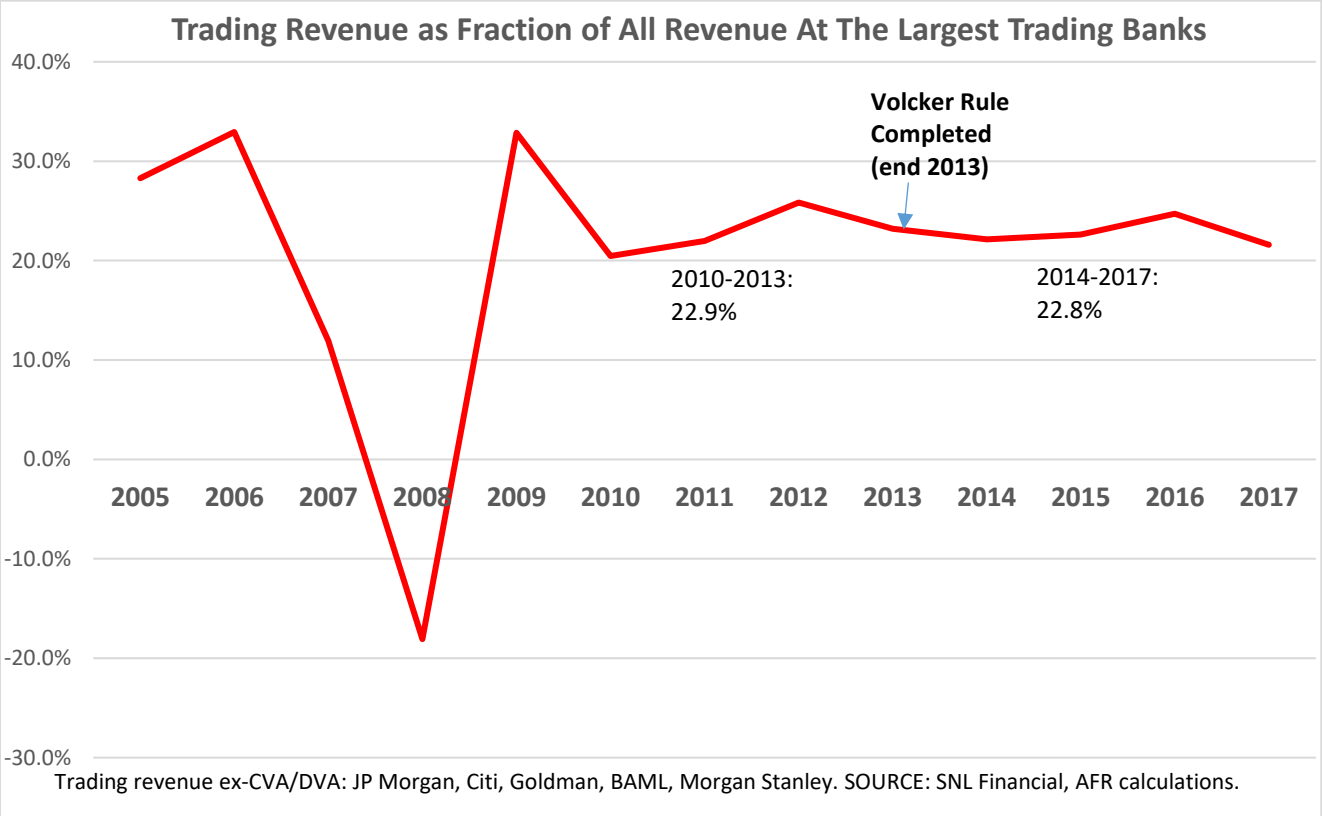
AFR Americans for Financial Reform

Education Fund

October, 2018

The Volcker Rule: Its Past, Present, and Uncertain Future



Trading revenue ex-CVA/DVA: JP Morgan, Citi, Goldman, BAML, Morgan Stanley. SOURCE: SNL Financial, AFR calculations.

Americans for Financial Reform Education Fund
1615 L Street NW Suite 450 Washington, DC 20006 | 202.466.1885 | realbankreform.org

Executive Summary

The Volcker Rule is a central element of post-crisis financial regulation that is intended to be a modern version of the Glass-Steagall division between commercial banks and Wall Street trading markets. The rule was a direct response to the business model that drove the 2008 financial crisis. It is now in danger of being weakened to the point of being ineffective.

This report describes the history of the rule and the efforts of the financial industry, aided in many cases by sympathetic regulators, to undermine it.

- The Volcker Rule directly targets the large bank business model that drove the 2007-2009 financial crisis, which was fundamentally rooted in the combination of proprietary trading and securitization activities conducted through Volcker-covered funds.

- At the time of the crisis, regulators freely admitted that proprietary trading books were central to bank losses. In 2008, banks like Citigroup and Bank of America/Merrill Lynch experienced proprietary trading losses of almost half of their tangible equity capital.

- The "toxic" loan securitizations at the heart of the 2008 crisis were versions of external capital market funds whose ownership by banks is banned under the Volcker Rule. Prior to the crisis, banks created and sold massive amounts of these funds, manipulating markets and deceiving customers to increase sales of their securitizations.

- Although the goal of the drafters of the Volcker Rule was fundamental systemic reform, the rule as implemented has apparently had far more limited effects. For example, at the largest U.S. trading banks, trading revenue as a share of total revenue has not declined since the final Volcker Rule began to be implemented.

- The combination of industry lobbying and the desire of some regulators to maintain a central role for regulated banks in Wall Street trading has already led to a weaker Volcker rule than the drafters of the statute intended. Yet the Trump Administration is now proposing to weaken the rule still further.

- The Volcker statute allows a very substantial role for regulatory discretion in its implementation. The lack of public disclosure on the rule makes definitive conclusions difficult, but it appears that regulators are using this discretion to undermine the fundamental intent of the rule.

- In light of this, the public needs to demand that either the Volcker Rule be made much stronger, or another approach be adopted that permits less regulatory discretion. The clear intent of the Volcker Rule was a modernized Glass-Steagall. If regulators continue thwart this objective, a return to the clearer and stricter statutory Glass-Steagall division between the commercial banking system and Wall Street trading markets is needed.

Introduction

Section 619 of the Dodd-Frank Act, otherwise known as the "Volcker Rule", was conceived of almost a decade ago as a way to restore firewalls between publicly insured commercial banking and speculative capital markets trading. The statute bans bank holding companies from proprietary capital markets trading, unless these activities are focused on specified customer needs such as market-making or underwriting. It also bans bank connections to capital market funds such as hedge funds, private equity funds, and a wide range of securitization vehicles which became "toxic" during the 2008 financial crisis. Finally, the Volcker Rule requires banks to eliminate conflicts of interest with customers that result from their capital markets activities.

From the start, the Volcker Rule has faced fierce opposition from opponents who claimed that no such structural reform was necessary, and that attempts to create it were misguided. These opponents have claimed that the activities targeted by the Volcker Rule were not central to the disastrous 2008 global financial crisis. They have claimed that the Volcker Rule would be impossible to implement, and that if implemented it would be harmful to financial markets. They have also done their best to neutralize the rule by pressing for numerous exemptions and accommodations to permit trading banks to continue pre-Volcker Rule practices.

With the new changes to the rule proposed by the current Administration, opponents of the Volcker Rule may be on the verge of getting their way. This report provides a background that places these current efforts to change the rule in context. It describes the roots of the Volcker rule in the attempt to rein in the proprietary big bank business models that were central to the 2008 crisis. It describes some key aspects of the initial version of the Volcker Rule that was passed at the end of 2013 and its effects on regulated banks and financial markets. Finally, it provides a conceptual summary and brief discussion of the Trump Administration's proposed changes in the rule and how these threaten to make an already compromised rule ineffective.

The history of the Volcker Rule is marked by the reluctance of regulators, reinforced by a massive industry lobbying effort, to take decisive steps to eliminate or even place major limitations on the bank proprietary trading model that proved disastrous during the 2008 financial crisis. As documented in this paper, the implementation of the current version of the Volcker Rule has not appeared to impact trading revenues at the major banks, and proposed changes in the rule will weaken it still further. If regulators will not use the considerable discretion provided to them under the Volcker Rule to take stronger steps to restrict bank proprietary trading, advocates of separating banking from capital markets there is more reason than ever to turn to approaches that involve less regulatory discretion – such as fully restoring Glass-Steagall.

The Volcker Rule as a Structural Response to the Financial Crisis

The 2007-2009 financial crisis taught hard lessons about the ways in which trading and fund activities of major banks could threaten the safety and soundness of the banking system, create conflicts of interests with customers, and permit the manipulation of broader asset markets. From the very first discussion of the Volcker Rule in a report by the Group of 30, a set of financial sector leaders which included Paul Volcker, the idea was a direct response to the failure of the banks' proprietary trading business model during the crisis:[1]

> "Recent experience in the United States and elsewhere has demonstrated instances in which unanticipated and unsustainably large losses in proprietary trading, heavy exposure to structured credit products and credit default swaps, and sponsorship of hedge funds have placed at risk the viability of the entire enterprise….These activities, and the "originate-to-distribute" model, which facilitated selling and reselling highly engineered packages of consolidated loans, are for the most part of relatively recent origin. In essence, these activities all step away from the general concept of relationship banking, resting on individual customer service, toward a more impersonal capital markets transaction-oriented financial system…"

These experts were absolutely correct in stating that bank proprietary trading losses and the banks' relationships to external funds were at the heart of the crisis. These two issues – proprietary capital markets trading and external funds activities – were deeply linked. Banks used their "trading books" (proprietary trading inventories) to support the "toxic" mortgage backed securities they generated and sold as supposedly external funds. Hundreds of billions of dollars of these securities were held in proprietary trading inventories, and mortgage securitizations themselves were structured as external investment vehicles by banks. In the years before the financial crisis, conventional regulatory methods such as capital requirements based on models of trading risks failed to predict or limit the catastrophic losses created by this business model.

Bank Trading Activities and the Crisis: The large role of bank trading book activities in contributing to the crisis is not controversial and was widely discussed among regulators. As a 2010 summary by international regulators of post-crisis reform efforts stated, "…the major losses during the 2007–09 financial crisis came from the trading book, especially the complex securitisation exposures such as collateralised debt obligations."[2] In the Turner Review, a comprehensive review of the financial crisis experience commissioned by U.K. regulators, the

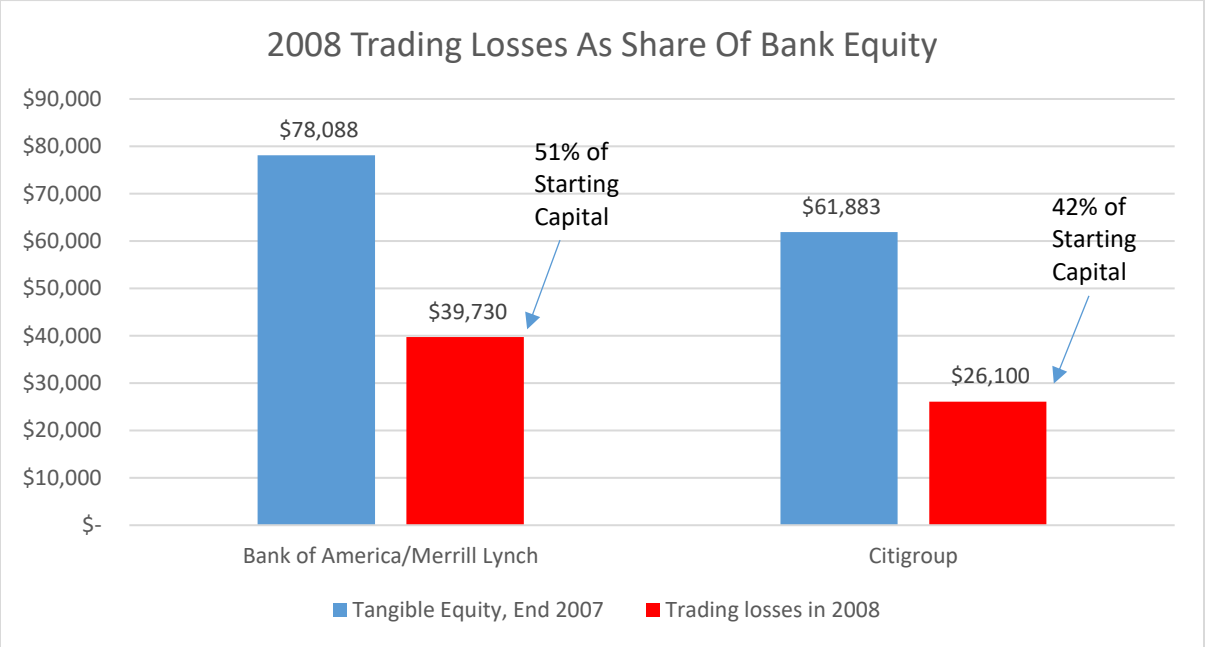
[1] Group of 30, "Financial Reform, a Framework for Financial Stability", January 15, 2009, Group of Thirty. http://group30.org/images/uploads/publications/G30_FinancialReformFrameworkFinStability.pdf
[2] Hannoun, Herve, "The Basel III Capital Framework: A Decisive Breakthrough". Speech at Hong Kong SAR, November 22, 2010. https://www.bis.org/speeches/sp101125a.htm

authors make clear that proprietary trading book activities were poorly regulated and were central to the buildup in bank leverage and risk at the heart of the crisis:[3]

> "capital requirements against trading books, where the asset growth was concentrated, were extremely light compared with those for banking books…It is clear in retrospect that the VAR measures of risk were faulty and that required trading book capital was inadequate."

It is no accident that risk measures were most flawed in the case of trading activities, since it is fundamentally more difficult to assess the risk of trading positions, which requires predicting trading prices, than it is to assess the risk of loans that are held by banks. Banks took advantage of this to arbitrage regulations and borrow more against traded positions based on the inflated market prices claimed for these positions.

A simple way to see the magnitude of bank trading losses is shown in the figure below, which illustrates that the two of largest U.S. depository banks at the time of the crisis – Bank of America and Citibank – lost about half of their tangible equity capital to trading losses in 2008.[4]



As large as they are, the losses in the chart above are probably a significant underestimate. They do not include losses in trade value due to declines in the creditworthiness of counterparties

[3] Turner, Adair, "The Turner Review", U.K. Financial Services Authority, March 2009. http://www.fsa.gov.uk/pubs/other/turner_review.pdf

[4] Tangible equity capital is shareholder's equity minus intangible capital, from 2007 corporate 10-Ks. 2008 trading losses from SNL financial. End of 2007 capital for Bank of America includes capital for Merrill Lynch.

("credit valuation adjustment" or CVA losses), a major issue at the time. They do not account for the fact that these and other banks were receiving massive assistance from Federal Reserve liquidity support programs, which were designed to help banks avoid trading losses. And because banks were sometimes able to manipulate accounting rules to avoid writing down assets to their current market value, the recorded trading losses in the chart do not include all the write downs that could or should have been made.[5]

Citibank and Bank of America/Merrill Lynch were perhaps the most systemically critical U.S. institutions suffering immense financial crisis losses tied to trading activities, but they were hardly alone. Foreign banking organizations vital to Wall Street stability, such as Deutsche Bank, UBS, and Credit Suisse, also suffered enormous trading losses. And some investment banks such as Goldman Sachs that avoided extreme trading losses managed to do so by imposing those losses on others, using deceptive practices to sell impaired assets to clients. The incentive to take advantage of clients in this way was driven by the conflict of interest created by bank proprietary trading, since banks sought to avoid proprietary losses in their trading inventories by deceiving investors into purchasing bad assets.[6]

Most of the trading losses in the crisis did not involve a single short-term trade, but instead declines in the market value of the large inventories of securities banks had stockpiled for supposed trading purposes. In the five years between 2002 and 2007, inventories of private securities held at banks and broker dealers more than doubled, from $635 billion to $1.5 trillion.[7] Most of these were nominally held for trading purposes. Due to the inadequate regulation of bank market risk capital noted above, these inventories were funded using large amounts of borrowed money and banks were highly vulnerable to losses in their value. The large trading inventories they amassed are a central indication that banks were not acting as market makers during the crisis but proprietary investors. True market makers do not hold securities inventories that are larger than the amount necessary to satisfy short term customer demand.

The Securitization Business Model, the Crisis, and The Volcker Rule: In addition to restricting proprietary trading, the Volcker rule generally bans bank ownership of "external funds". The fund activities banned under the rule include not only conventional hedge funds and private equity funds, but also a wide range of other funds, including "structured investment vehicles"

---

[5] Pozen, Robert, "Is It Fair to Blame Fair-Value Accounting for the Financial Crisis?", Harvard Business Review, November, 2009. https://hbr.org/2009/11/is-it-fair-to-blame-fair-value-accounting-for-the-financial-crisis

[6] Securities and Exchange Commission, "Goldman Sachs to Pay Record $550 Million To Settle SEC Charges Related to Subprime CDO", Press Release, July 15, 2010. https://www.sec.gov/news/press/2010/2010-123.htm; Senator Carl Levin, "Opening Statement of Senator Carl Levin: Wall Street and the Financial Crisis, The Role of Investment Banks", Senate Permanent Subcommittee on Investigations, April 27, 2010, https://www.hsgac.senate.gov/imo/media/doc/OPENINGLEVINCarlApril272010.pdf

[7] Excludes government guaranteed and GSE backed securities. Source: Federal Reserve Flow of Funds, Inventories of Corporate and Foreign Bonds, Series FL703063005.A (Banks) and Series FL663063005 (Securities Brokers), years 2002 to 2007.

(SIVs) used by banks to create loan securitizations. These restrictions on bank involvement with external funds, particularly securitizations, are central to understanding the Volcker Rule and how it directly addresses the issues revealed in the 2008 financial crisis.

The creation, marketing, and sale of loan securitizations by too big to fail banks was at the heart of the financial crisis. Instead of simply holding loans on their books, or acting as brokers of pre-existing securities to investors, large Wall Street banks created a new business around repackaging loans into complex securitized products. They then sold these securitizations to investors, who found it difficult to judge the quality of the underlying loans in these complex products. This business generated massive profits for the banks. Especially in the years just before the crisis, the desire for more mortgages to put into securitizations was actually driving the poor quality of subprime loans made to ordinary borrowers. Chuck Prince, the CEO of Citigroup, described the situation to the Financial Crisis Inquiry Commission:[8]

> "As more and more of these subprime mortgages were created as raw material for the securitization process, not surprisingly in hindsight, more and more of it was of lower and lower quality. And at the end of that process, the raw material going into it was actually bad quality, it was toxic quality, and this is what ended up coming out the other end of the pipeline."

Although the vehicles used to create securitizations were nominally external to the bank, banks were in fact exposed to large amounts of risk when the underlying securitization assets lost value. Securitization-related losses were a central contributor to the crisis.[9]

No securitization market was more complex or became more "toxic" than the market for collateralized debt obligations, or CDOs. Rather than being limited to loans, CDOs generally contained pieces of other securitizations, as well as derivatives replicating these exposures. Banks used CDOs to repackage pieces of primary securitizations that were too risky to be sold directly to investors, camouflaging their quality by burying them in yet another securitized product. Control of CDOs was usually delegated to a nominally independent external investment manager. But these managers often acted as fronts for the large banks that supported the CDO markets by designing, underwriting, and selling the securities.[10]

---

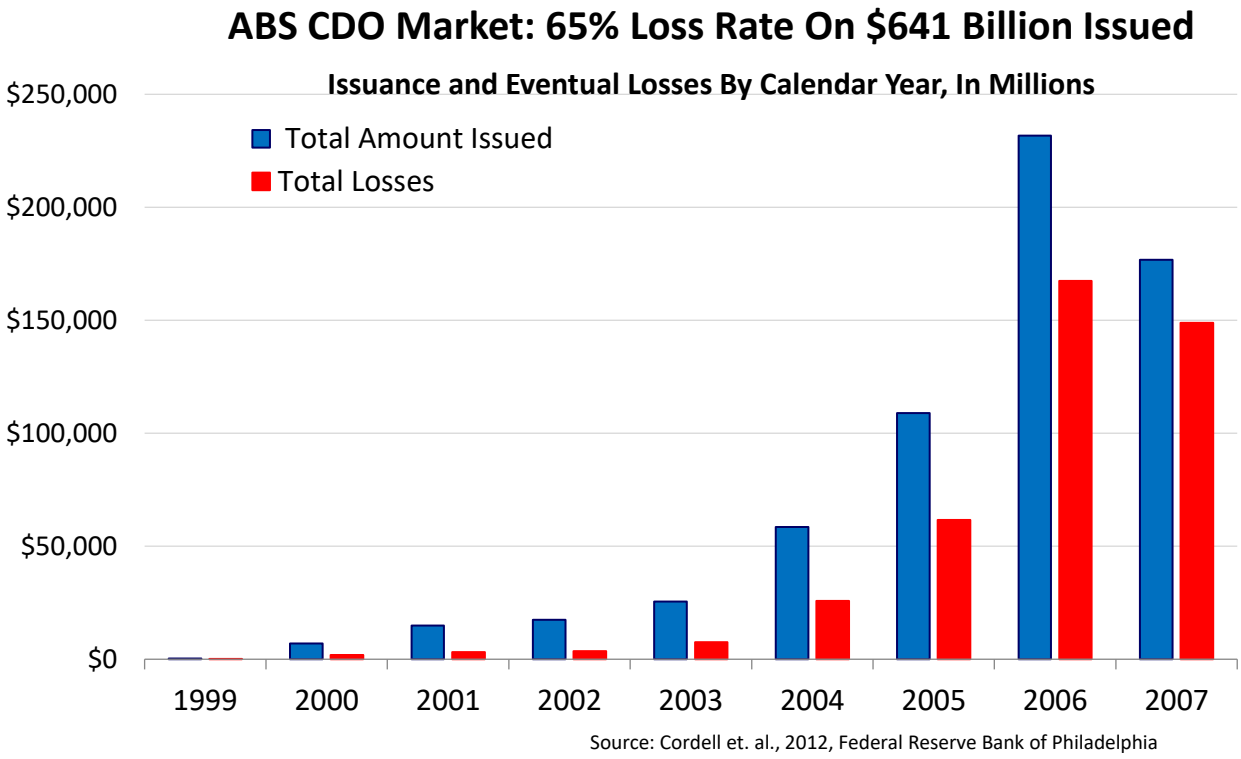
[8] Pp. 102-103, Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report", Government Printing Office, January 2011. https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf

[9] Tett, Gillian, "Structured Investment Vehicles Role in the Crisis", Financial Times, August 12, 2007. https://www.ft.com/content/8eebf016-48fd-11dc-b326-0000779fd2ac ; Acharya, Viral V. and Schnabl, Philipp and Suarez, Gustavo, "Securitization Without Risk Transfer", October 20, 2011. AFA 2010 Atlanta Meetings Paper. https://ssrn.com/abstract=1364525

[10] Chernenko, Sergey, "The Front Men of Wall Street: The Role of CDO Collateral Managers in the CDO Boom and Bust", October 18, 2016, Journal of Finance, Forthcoming; Charles A. Dice Center Working Paper No. 2015-12 https://ssrn.com/abstract=2629137

The securitization business model was fundamentally linked to proprietary trading as well. Large bank trading inventories of securitizations were an important element of support for the market, especially for CDOs. These trading inventories were used to stockpile unsold securities and also provide artificial liquidity for a market that sometimes had few true external buyers. There is extensive documentation that bank self-dealing provided critical support for the CDO market prior to the crisis.[11] In this sense, the banks were engaged not just in speculating on the market but in large-scale market manipulation as well, using their trading power to create and expand markets which would have had only limited external demand. The size and centrality of the largest trading banks gave them unprecedented resources for such manipulation.

As the figure below shows, banks generated vast volumes of CDO instruments in the pre-crisis period, and losses on these securities were enormous.



Indeed, the $641 billion of CDO securitizations that traded from bank CDO desks prior to the crisis lost fully two-thirds of their value. This is despite investment grade credit ratings that led investors to believe that the securities were extremely safe and losses would be minimal.

[11] Bernstein, Jake and Jesse Eisinger, "Bank Self-Dealing Super Charged Financial Crisis", Pro Publica, August 26, 2010. https://www.propublica.org/article/banks-self-dealing-super-charged-financial-crisis ; Bernstein, Jake and Jesse Eisinger, "A Bank's Best Customer: It's Own CDOs", Pro Publica, August 26, 2010. https://www.propublica.org/article/a-banks-best-customer-its-own-cdos

The set of activities banned by the Volcker Rule were at the heart of these pre-crisis abuses. Banks used their ability to create external funds to package and sell highly speculative and risky securitizations, whose true quality they concealed from investors, and then used their proprietary trading activities to support and manipulate markets for these securities. In addition to restricting the fundamental building blocks of this business model, the Volcker Rule also bans the bank conflicts of interest that drove large scale fraud in pre-crisis securitization markets.[12]

The creators of the Volcker Rule were clearly seeking serious structural reform to eliminate the proprietary trading business model that caused the crisis. In a July 15, 2010 legislative colloquy between Senators Merkley and Levin, the drafters of the new law, Senator Merkley makes clear that the Volcker Rule was motivated by the need for structural reform akin to a modern version of the Glass-Steagall Act:[13]

> "The 'Volcker Rule'…embraces the spirit of the Glass-Steagall Act's separation of 'commercial' from 'investment' banking by restoring a protective barrier around our critical financial infrastructure….While the intent of Section 619 is to restore the purpose of the Glass-Steagall barrier between commercial and investment banks, we also update that barrier to reflect the modern financial world….Section 619 seeks to reorient the U.S. banking system away from leveraged short-term speculation and toward the safe and sound provision of long-term credit to families and business enterprises."

This ambitious agenda would not be simple to implement. It would face major opposition from both affected banks and regulators who preferred a less far-reaching approach.

From Statute to Rule: Regulators Define the Volcker Rule

The statutory language of Section 619 of the Dodd-Frank Act lays out a general ban on bank proprietary trading and ownership of covered external funds, and also bans banks from engaging in activities that would involve a material conflict of interest with clients. However, a number of other trading and fund activities continue to be permitted. These include trading for market-making, underwriting, and hedging purposes, so long as these are aligned with the reasonably expected near-term demands of customers. The exact definition and parameters of permitted activities are left to regulators to define. Furthermore, in Section d(1)(J) of the statute regulators

[12] Fligstein, Neil and Alexander Roehrkasse, "The Causes of Fraud in Financial Crisis of 2007 to 2009: Evidence From Mortgage Backed Securities", American Sociological Review, June 23, 2016, http://journals.sagepub.com/doi/abs/10.1177/0003122416645594 . Koszeg, Fanni, "Will CDO Managers Be Held Responsible for Their Role in the Financial Crisis?", Bloomberg Law, October 22, 2012. https://www.bna.com/cdo-managers-held-n17179870393/

[13] Colloquy of Senators Levin and Merkley, Congressional Record, July 15, 2010, p. S5894-S5899, available at http://graphics8.nytimes.com/packages/pdf/business/Economix-Merkley-Levin-Detailed.pdf

are given the general authority to make additional exemptions that they believe "would promote and protect the safety and soundness of the banking entity and the financial stability of the United States." The ability to define such broad terms as market-making, underwriting, and hedging, along with a general ability to craft further exemptions to the rule, means that regulators have enormous discretion to define how the Volcker Rule looks in practice.

The process of moving from the statute to an actual rule that could be implemented, which involved extensive work to define permitted activities, stretched over more than three years. The Dodd-Frank Act was passed in July, 2010 but the regulators' Final Rule was not released until December, 2013. Over that period, banks engaged in extensive lobbying of regulators. One study found that in the period between passage of the Dodd-Frank Act and the passage of the final rule, financial institutions, law firms, and industry trade groups personally met over 1,100 times with regulators. This is more than one industry meeting per working day for over three years.[14] The Volcker Final Rule reflects this intensive lobbying effort.

The Final Rule also reflects the fact that some regulators, both at Tim Geithner's Treasury and at the Federal Reserve, fundamentally disagreed with the Volcker Rule approach of limiting bank activities.[15] These regulators questioned the need to restrict what banks could do, and were concerned that restricting banks' ability to do proprietary trading could be harmful to the markets. Instead, they favored updating the models-based approach to risk that had failed prior to the 2008 crisis. Issues with this perspective are discussed further in the conclusion to this paper, but it is worth noting that it had a significant influence on the development of the Volcker Rule.

The 2013 Final Rule did constrain bank activities in some significant ways, which is an important reason why there is currently such pressure to roll it back. However, the combined forces of industry lobbying and regulatory conservatism led to a final rule that was significantly weaker than the vision laid out by drafters of the legislation, and contained numerous bank-friendly interpretations and exemptions. Some of these are described below.

Determining what trading is permitted market-making: One of the most important Volcker Rule questions is how to determine what kind and amount of trading is permitted as "market making". A narrow definition of market making that was strictly limited to servicing verifiable customer demand would significantly cut down on bank trading. A definition that gives banks broad leeway to label even speculative trades as market-making (e.g. because the bank argues some future customer could eventually want the product) might not affect trading much at all.

---

[14] See Figures 2 and 4 in Krawiec, Kimberly and Guangya Liu, "The Volcker Rule: A Brief Political History", Capital Markets Law Journal, September 2015.
https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=6191&context=faculty_scholarship
[15] Cassidy, John, "The Volcker Rule", The New Yorker, July 26, 2010.
https://www.newyorker.com/magazine/2010/07/26/the-volcker-rule

Banks lobbied this issue heavily prior to the final rule. They insisted that detailed transaction-by-transaction scrutiny of trades would excessively limit big banks' role in the markets. To a large degree, they won. Regulators abandoned the idea of transaction-by-transaction scrutiny of trades in determining which trades were permitted market-making. Instead, regulators chose to collect a set of seven aggregated (summary) metrics of inventory and exposure for each trading desk and not to individually scrutinize trades at all. In the Final Rule regulators explicitly stated that they rejected the approach of scrutinizing each transaction because it was seen as "unduly burdensome" to banks and might lead trading banks to "significantly reduce" market making activities, which would lead to "negative effects" on markets.[16] Thus, regulators explicitly prioritized the supposed necessity of large banks conducting extensive trading activities over a strict approach to limiting proprietary trading.

The current rule therefore relies on aggregated trading metrics that summarize overall trading activity, rather than scrutiny of individual trades. The metrics include such basic measures as the inventory of traded securities or derivatives, the frequency of turnover, standard risk limits, the source of profit and loss, and the relationship of trading to customer demand. Regulators have apparently not set out any clear numerical bright line for when these aggregate metrics indicate proprietary trading. Proprietary trading is determined based on supervisory judgement. The standards used for such supervisory judgement are unclear and have not been publicly disclosed.

The lack of any clear public disclosure about how metrics are actually being used creates uncertainty about whether enforcement is adequate. In addition, with no scrutiny of individual trades, it is unclear whether traders can be able to net out the risk of individual positions in ways that conceal the risks of individual trades, or simply conceal individual trades altogether.[17] Informed analysts have also expressed the view that the quality of even the aggregate metrics is unreliable due to shortcomings in bank data analysis and availability of information to regulators – an issue only made worse by the failure to disclose detailed information to the public.[18]

In sum, the desire to avoid undue burden to banks and to limit the market impacts of the rule has led to a metrics-based proprietary trading framework that is vague, complex and highly

[16] Footnote 711, "Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds", Final Rule, Federal Register, January 31, 2014. https://bit.ly/2JWVVMa

[17] At the large French bank Societe Generale a single low level trader named Jerome Kerviel successfully concealed tens of billions of dollars in trades for years to hide his personal proprietary trading activities. See Societe Generale, "Mission Green: Summary Report", General Inspection Department, May 20, 2008. https://bit.ly/2e3bLT4

[18] Valladares, Mayra Rodriguez, "Getting the Volcker Rule Right May Be a Waste of Time", Bank Think, American Banker, August 15, 2018. https://www.americanbanker.com/opinion/getting-the-volcker-rule-right-may-be-a-waste-of-time

discretionary. A related problem is that public disclosure has been lacking on how regulators have actually used these metrics or how much they truly limit bank trading activities.[19]

Still, despite these serious concerns, current trading limitations are potentially of some value. They should limit buildup of trading inventories by linking them to clear documentation of external customer demand. Depending on implementation, they could prevent buildup of risky trading inventory in systemically critical banks and restrict the ability of banks to manipulate markets as they did prior to the 2008 crisis. The lack of public data and disclosure makes it hard to tell how substantial this impact has been. But the fact that industry continues to devote resources to trying to weaken the rule suggests that it does impose some constraints.

Relationships with covered funds: If implemented strictly as drafted the covered fund provisions of the Volcker Rule would have severely restricted bank relationships with securitization vehicles. This would have forced major adjustment in the pre-crisis model under which too big to fail banks created, promoted and sold huge numbers of securitizations. Banks also lobbied regulators heavily to maintain their securitization role, arguing that they should be restricted from a much narrower range of hedge and private equity funds.

Again, bank lobbying efforts saw major success. In Section __10(c) of the 2013 Final Rule, regulators added over thirteen major regulator-created exemptions to the definition of covered funds laid out in the statutory text of the Dodd-Frank Act.[20] These regulator-created exemptions include exemptions from Volcker Rule restrictions for a wide range of loan securitizations and asset backed commercial paper vehicles, including numerous types of vehicles which were involved directly in the 2008 financial crisis. Besides expanding permitted bank activities, the exemptions add significantly to the complexity of the statutory Volcker Rule, which defined covered funds in a relatively straightforward manner.

At the same time, regulators did impose some restrictions on bank securitization and covered fund activities as compared to what was permissible before the crisis. The final Volcker Rule limits were intended to prevent re-securitizations (securitizations that repackage pieces of other securitizations) or synthetic securitizations (securitizations that are constructed from derivatives rather than underlying loan securities). If effectively implemented, this kind of ban would have

[19] Americans for Financial Reform, "Letter to Regulators on Volcker Rule Disclosure", December 17, 2015. http://ourfinancialsecurity.org/wp-content/uploads/2015/12/AFR-Volcker-Joint-Letter-12.17.15-1.pdf . Bair, Sheila and Gaurav Vasisht, "The Volcker Rule Needs Transparency More Than Simplification", Wall Street Journal, September 9, 2018. https://www.wsj.com/articles/the-volcker-rule-needs-transparency-more-than-simplification-1536524547

[20] Unlike the exemptions for trading activities and market-making, these exemptions are not directly referenced in the statute but were created by regulators. In the Final Rule regulators argued that the statute gave them wide authority to exempt particular types of funds from the definition of covered funds clearly laid out in the statute. See the discussion of permissible interpretations of Section 13(h)(2) of the BHC in Part IV(B)(1)(b) of the 2013 Final Rule, CFR 5670 in the Federal Register version. Available at https://bit.ly/2JWVVMa

sharply limited bank involvement in the pre-crisis CDO market. Other types of speculative securitizations such as arbitrage CDOs also do not qualify for the exemptions. These are some of the most complex and potentially "toxic" financial instruments that can be produced and marketed, and have the least connection to supporting productive economic activity. The Volcker Rule restrictions on covered funds also restrict bank control over the managers of external securitizations, preventing the use of supposedly external managers as "fronts" for bank control.

The above are only some of the most notable exemptions and accommodations provided in the 2013 Final Rule. Numerous other major regulator-created exemptions exist in the rule. To take an egregious example, regulators weakened the Volcker Rule's statutory ban on conflicts of interest with customers and investors. In most cases, this statutory ban can be satisfied not by entirely eliminating conflicts of interest but instead purely through disclosure of such conflicts.[21]

The final Volcker regulation was clearly weaker than the drafters intended. As Senators Merkley and Levin, the main drafters of the statute, stated in their comment on the proposed regulation:[22]

> "As a starting point, we think the Proposed Rule is simply too tepid. In adopting the Merkley-Levin Provisions, Congress sought to fundamentally change the financial system of this country by restoring and modernizing safeguards that, for decades, protected the country from the types of financial abuses that caused the 2008 financial crisis. Congress also sought to impose explicit prohibitions on the conflicts of interest and risks that helped exacerbate that crisis. The Proposed Rule does not fulfill the law's promise. Instead, the Proposed Rule seems focused on minimizing its own potential impact. It engages in contortions that appear aimed at trying to restrict banks' trading without impacting the volume of banks' overall trading in the markets. That is not an objective of the Merkley-Levin Provisions."

What Has the Volcker Rule Done in Practice?

In the absence of more extensive public disclosure on the implementation of the 2013 Final Volcker Rule, the impact on bank practices is unclear. However, anecdotal reports indicate that numerous proprietary traders have exited banks for non-banks such as hedge funds.[23] Volcker Rule restrictions on external funds have eliminated bank-owned hedge funds, and, combined with changes in capital rules, have also restricted some of the most toxic of the pre-crisis

[21] See Section _.7(b) of the Final Rule. https://bit.ly/2JWVVMa
[22] Senators Jeff Merkley and Carl Levin, "Comment Letter on Proposed Rule to Implement Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds", February 13, 2012. https://www.sec.gov/comments/s7-41-11/s74111-362.pdf
[23] Roose, Kevin, "Stop Asking if the Volcker Rule Will Work: It Already Has", New York Magazine, December 11, 2013. http://nymag.com/daily/intelligencer/2013/12/stop-asking-if-the-volcker-rule-will-work.html

securitization instruments, such as synthetic securitizations.[24] Recent Federal Reserve analyses of bank trading practices have also indicated that the level of measured risk associated with trading practices has declined, although it is likely that this is due at least partially to factors outside of the Volcker Rule.[25]

At the same time, consistent with the relatively permissive rule they wrote, regulators have apparently shown great deal of leniency and flexibility in their enforcement of the Volcker Rule. Evidence for this is described below.

The Current Volcker Rule Allows Generous Scope for Trading: In the three years since the Volcker Rule conformance period ended, there is only one example of a bank being penalized for violation of the rule. In that instance, Deutsche Bank was fined $20 million for its self-admission that its Volcker compliance program was inadequate.

However, there have been many other reports of aggressive trading patterns that seem indicative of proprietary trading, but have not been penalized. For example, a single Goldman Sachs trader made more than $100 million trading aggressively in the junk bond market, over a few months at the beginning of 2016.[26] To take another prominent example, Credit Suisse apparently failed to properly monitor its trading inventory holdings of distressed debt, leading to unexpected losses of close to a billion dollars.[27] We are not aware of any enforcement actions taken by regulators in these cases, and certainly there was no public penalty. In the absence of adequate public disclosure on Volcker Rule implementation, it is difficult to tell whether these particularly large and aggressive trading patterns represent unusual instances or are symptomatic of broader patterns in bank trading activities. But the lack of penalties in these cases is evidence of the wide range of trading activities that banks are apparently able to classify as market making.

An examination of broader trends in trading revenue and trading inventories also shows that banks have been able to maintain very robust trading operations under the Volcker Rule. As Senators Merkley and Levin warned in their initial comment on the regulations, banks appear to have been able to maintain their overall volume of trading in the markets. The chart below shows annual trading revenues from 2005 to the close of 2017 as a percentage of total revenues for the five largest U.S. trading banks.[28]

---

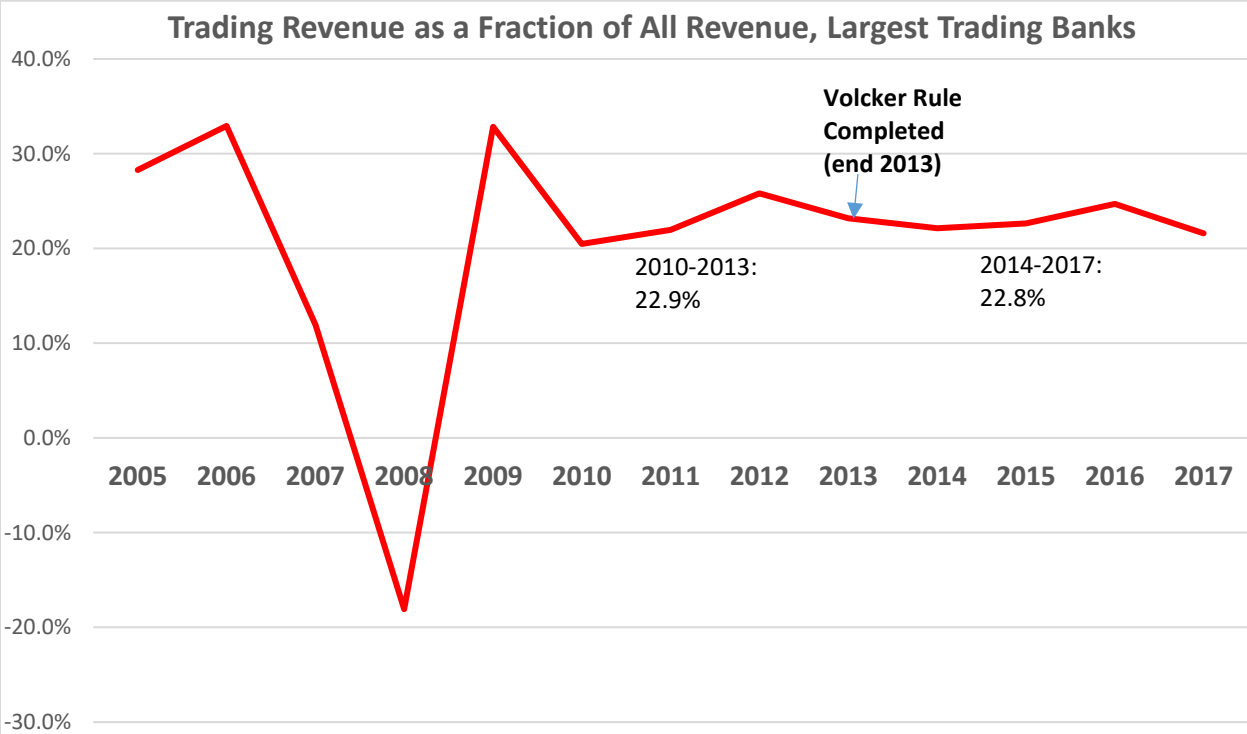
[24] http://www.mondaq.com/unitedstates/x/489592/The+Transformation+Of+Securitisation+In+An+Evolving+Financial+And+Regulatory+Landscape

[25] Iercosan, Diana et. al., "Trading Activities at Systemically Important Banks: Part 1, Trading Performance", Feds Notes, July 10, 2017. https://bit.ly/2t6gaub

[26] Baer, Justin, "How One Goldman Sachs Trader Made More Than $100 Million", Wall Street Journal, October 19, 2016. https://bit.ly/2xX73kJ

[27] Office of Senator Jeff Merkley, "Letter To Regulators Regarding Trading Losses at Credit Suisse", May 5, 2016. https://bit.ly/2IAkSd4

[28] Bank of America, Citibank, Goldman Sachs, JP Morgan, and Morgan Stanley.



Trading revenue ex-CVA/DVA: JP Morgan, Citi, Goldman, BAML, Morgan Stanley. SOURCE: SNL Financial, AFR calculations.

At least so far the finalization and implementation of the Volcker Rule appears to have made little difference in the significance of trading revenues as a share of bank income. Trading revenues represented 20.5 percent of total revenues in 2010, before the Volcker Rule was passed, but 21.6 percent of total revenues in 2017, four years after the final rule began to be implemented. It is true there is substantial year to year variance in trading revenues, but no clear pattern of decline is visible. Over the four years from 2010 to 2013 -- when regulators had not completed and were not enforcing the Volcker Rule and there was great uncertainty about what the rule would do -- the major Wall Street banks earned 22.9 percent of their total revenues from trading. Over the four years from 2014 to 2017, when the rule had been finalized and was supposedly being implemented, banks earned 22.8 percent of their total revenues from trading, an almost identical figure. Both of these figures are lower than pre-crisis trading revenues, or trading revenues during 2009, when extensive Federal Reserve assistance combined with low interest rates contributed to a trading spike. But there has been no tendency for trading revenues to drop as the Volcker Rule has been finalized and implemented.

Another measure of the significance of trading to the banks' business models emerges from considering the inventory of trading assets compared to total assets. Here there is a slight decline in trading assets after the , with trading assets as a share of all banking system assets declining gradually from about 12 percent in 2010 to 9 percent in the first quarter of 2018. However, most

of this decline occurred before the Volcker Rule was finalized at the end of 2013. Overall trading inventories still remain large, with a total of $1.9 trillion in trading inventories held by banks.[29]

Since the Volcker Rule permits market making and certain other trading activities, there is no contradiction in significant trading activity occurring under the rule. But the fact that no decline in trading revenue has been observed at the major trading banks during the Volcker implementation period, and trading inventories still remain large, is evidence that the rule as implemented permits ample space for trading activities in the banking system.

Broader Market Liquidity Has Remained Strong During Volcker Implementation: Over the past several years the financial industry has raised numerous concerns that the implementation of both enhanced capital requirements and the Volcker Rule would be harmful to market liquidity, particularly trading liquidity in the fixed income markets. However, these fears have not been borne out by the evidence. Primary bond market liquidity has demonstrably been high, with new records set for total corporate bond issuance during each year from 2011 through 2017.[30] In terms of secondary market liquidity, numerous recent studies have found that market liquidity, as measured by trading volume and total costs, has been strong over the post-crisis period. For example, an extensive 2016 study by the New York Federal Reserve found that bond market trading volume has increased and the costs of trading bonds have declined since the passage of the Dodd-Frank Act, and remained low during the period of Volcker Rule implementation.[31] A more recent study by the Securities and Exchange Commission summarized this and other evidence to produce a comprehensive review of changes in market liquidity since the financial crisis. The study finds no evidence of a decline in either primary or secondary market liquidity.[32]

There have been studies that looked at small selected elements of the market and claimed to find some evidence of a negative impact of the Volcker Rule. For example, a 2016 Federal Reserve discussion paper presented evidence that a small and non-representative fraction of downgraded "junk" bonds may have become slightly more expensive to sell around the time the Volcker Rule was implemented.[33] While some sought to portray this paper as demonstrating negative impacts of the Volcker Rule, the tiny fraction of bonds involved, the fact that they were the riskiest types

---

[29] From Federal Reserve Bank of New York, "Quarterly Trends For Consolidated U.S. Banking Organizations", https://www.newyorkfed.org/research/banking_research/quarterly_trends.html

[30] See Securities Industry and Financial Markets Association, "US Bond Market Issuance and Outstanding". https://www.sifma.org/resources/research/us-bond-market-issuance-and-outstanding/

[31] Adrian, Tobias, Michael Fleming, Or Shachar, and Erik Vogt (2016), "Market Liquidity After the Financial Crisis", Federal Reserve Bank of New York Staff Reports No. 796, October, 2016. https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr796.pdf?la=en

[32] Securities and Exchange Commission, "Access To Capital and Market Liquidity", Report by the Division of Economic and Risk Analysis", August, 2017. https://bit.ly/2wLYBC5

[33] Bao, Jack, 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.

of bonds and may not have been appropriate for holding by regulated banks, and the minor price impact found in the report, mean that its policy implications are limited at best.[34]

An Effective Volcker Rule Could Potentially Limit Market Liquidity: Although there is no evidence of a decline in market liquidity due to the Volcker Rule, it should be noted that this is not the proper metric by which to assess the rule. Market participants will always tend to argue for increased liquidity, as more market activity directly increases their profits. But as many economists have noted, a key lesson of the 2008 crisis is that market liquidity can be excessive and drive destabilizing cycles of boom and bust.[35] The existence of excessive market liquidity (a credit bubble) prior to the 2008 crisis was readily apparent to market participants at the time.[36] Indeed, prior to the crisis it was commonplace to see discussions of a "liquidity glut" or "wall of liquidity" that worked to compress spreads to an unhealthy degree.[37] As discussed in the previous section, the bank proprietary trading model fed this excessive liquidity as banks pumped out an unsustainable level of securitized lending and supported this market by means that included self-dealing and deception of investors.

It is entirely possible that an effective Volcker Rule could work to restrain liquidity to a level that is sustainable over the economic cycle and does not lead to excessive inflation in asset prices. At some point in the economic cycle, one would expect the Volcker Rule to restrain excessive liquidity. The evident fact that the current Volcker Rule regime has not had such an impact could simply be evidence that the rule is not very restrictive.

New Proposals Would Further Weaken the Volcker Rule

Despite the success of big banks in winning accommodations for their trading activities in the current Volcker Rule, they are still lobbying hard to weaken the rule. The current rule does put in place a compliance structure intended to limit trading inventory to a level commensurate with near term customer demand, and places some limits on external fund activities. Thus, the major trading banks continue to have an interest in undermining the rule. In addition to the banks own interests, some banking regulators (particularly the Federal Reserve) have continued to claim that

[34] http://ourfinancialsecurity.org/wp-content/uploads/2017/02/AFR-Response-to-Federal-Reserve-Discussion-Paper-1.pdf
[35] See e.g. Brunnermeier, Markus K. and Pedersen, Lasse Heje, "Market Liquidity and Funding Liquidity" (June 2009). *The Review of Financial Studies*, Vol. 22, Issue 6, pp. 2201-2238, 2009. Brunnermeir, Markus, K. "Deciphering The Liquidity and Credit Crunch of 2008", *Journal of Economic Perspectives*—Volume 23, Number 1—Winter 2009.
[36] Berman, Dennis K. 2007. "Sketchy Loans Abound: With Capital Plentiful, Debt Buyers Take Subprime-Type Risk." *Wall Street Journal*, March 27, page C1.
[37] Rajan, Raghuram, "Investment Restraint, the Liquidity Glut, and Global Imbalances", Remarks by Raghuram G. Rajan, Economic Counselor and Director of Research, IMF At the Conference on Global Imbalances organized by the Bank of Indonesia in Bali November 16th 2006. https://bit.ly/2QsbRFL

the Volcker Rule approach of limiting bank activities is inferior to traditional prudential regulatory methods that emphasize capital requirements.

These criticisms became more prominent during the Trump Administration. The Treasury Department's report on bank regulation issued in mid-2017 gave the first indication of the new Administration's direction with regard to the rule.[38] The five major recommendations in this report – and their potential implications for the rule – are briefly summarized below.

"Simplify the Definition of Proprietary Trading" – This recommendation refers to narrowing the definition of the trading activities to which the Volcker Rule would even apply. Assets held outside of "trading accounts" are not even monitored under the Volcker Rule and no Volcker restrictions apply to them. If the definition of trading account was improperly or excessively narrowed, this would free banks to trade outside of the rule altogether.

"Provide Increased Flexibility for Market Making" – This recommendation is based on the assumption that the current definition of permitted market making under the rule does not permit banks sufficient scope for their trading activities. Given that bank trading revenues remain strong, and that current enforcement does not scrutinize individual trades and has not resulted in known violations or penalties to banks, it is difficult to see the argument for this claim.

To add flexibility, the report recommends that banks be permitted to avoid the restriction that their trading volumes and inventory buildup be specifically linked to a measurement of reasonably expected near term customer demand (RENTD). Instead, the report recommends that banks be permitted "to focus less on predicting with precision the future demands of clients based on past patterns, and should have greater leeway to anticipate changes in markets that could increase demand", that banks which have "not yet established a market-making presence in a particular asset class should have more discretion to meet the RENTD condition while they are building up customer volume", and that in some cases banks should be permitted to opt out of RENTD limitations altogether.

These changes would allow banks to conduct trading activities based on speculation about possible future customer demand, rather than being limited by what customers are currently asking for. In doing so, they would expand the ability of the giant trading banks to engage in large-scale market manipulation, such as the manipulation that created the "toxic" securitization markets like the subprime CDO market prior to the 2008 financial crisis.

"Reduce the Burden of Hedging Business Risks" – The Volcker Rule allows banks to conduct trades for the purpose of "hedging" their positions in order to reduce risks. The current regulation

[38] Page 71 and following, U.S. Department of the Treasury, "A Financial System That Creates Economic Opportunity: Banks and Credit Unions", June, 2017. https://bit.ly/2sVxOlt

requires that any such hedging trades actually demonstrate that they reduce the risk of a specific identified position in order to count as risk reducing. The report criticizes such requirements as "overly burdensome" and recommends that regulators remove current requirements to document and demonstrate that hedges reduce particular risks and continue to reduce such risks over time.

However, in the absence of such requirement, speculative trades could be conducted based on a generalized claim that the trade reduced risk, even if it actually increased risk. This is exactly what happened in the JP Morgan "London Whale" case, when bank traders lost some $6 billion conducting speculative trades they had claimed were for the purpose of reducing risks.[39]

"Focus and Simplify Covered Fund Restrictions": This is a recommendation to add still more exemptions to the already existing thirteen regulator-created exemptions to the Volcker Rule ban on bank ownership of external covered funds. The report suggests that the exemptions be broadened to include more types of external funds that are currently banned under the Volcker Rule but are not specifically labeled as hedge or private equity funds. This could permit banks to once again own without restriction the most complex types of CDOs that were at the center of the 2008 financial crisis, including re-securitizations and synthetic securitizations.

"Reduce the Burdens of the Volcker Rule's Compliance Regime": This recommendation suggests that a wide variety of banks that are not among the largest few trading banks in the U.S. be exempted from the Volcker Rule's oversight and enforcement regime.

In May, 2018 regulators followed up on these initial recommendations with a detailed rule proposal.[40] At over 373 pages long, including over 400 questions for the public to answer, this rulemaking proposal is much longer, denser, and more technical than the initial Treasury recommendations. Yet conceptually it follows these recommendations closely.

For example, the rulemaking proposes to "increase flexibility for market making" by effectively exempting banks from requirements to align their trading with specified measures of upcoming customer demand so long as trading complies with risk limits set by the banks themselves. Banks would no longer be required to tie these limits to verifiable metrics of customer demand, and would be granted vastly increased discretion in this key area. This is despite the fact that, as discussed previously, the current rule already grants a great deal of discretion on trading controls to both banks and regulatory supervisors.

Weakening market making restrictions to the point where almost any trading activities could be defined as market making and thus permitted under the Volcker Rule has long been a goal of

[39] U.S. Senate Permanent Subcommittee on Investigations, "JP Morgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses", Majority and Minority Staff Report, March 15, 2013. https://bit.ly/2DRdwDa
[40] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180530a.htm

opponents of the rule. Indeed, this danger was singled out by the authors of the legislation at the time it was drafted. In the July 15th, 2010 Senate floor speech explaining the intent of the bill, Senator Merkley stated:[41]

> "…market making related is not a term whose definition is without limits. It does not implicitly cover every time a firm buys an existing security with the intent to later sell it, nor does it cover situations in which a firm creates or underwrites a new security with the intent to market it to a client. Testimony by Goldman Sachs Chair Lloyd Blankfein and other Goldman executives during a hearing before the Permanent Subcommittee on Investigations seemed to suggest that any time the firm created a new mortgage related security and began soliciting customers to buy it, the firm was "making a market" for the security". But one-sided marketing or selling securities is not equivalent to providing a two-sided market for clients buying and selling existing securities"

By weakening or eliminating the connection between observed customer demand and market-making restrictions, recent proposals make it easier for banks to manipulate markets and create false demand for flawed securities just as they did before the 2008 crisis.

Undermining the definition of market making is not the only way the new rule proposal would weaken the Volcker Rule. The rulemaking also proposes to "reduce the burden of hedging business risks" by eliminating requirements to document and demonstrate that risk-reducing trades hedge the risks of a specific position and continue to do so over time. This could open the door to "hedging" vague or generalized risks in a manner indistinguishable from proprietary speculation. While the proposal does not specify new exemptions from covered fund restrictions, it clearly contemplates them – the proposal contains dozens of questions asking for respondents to recommend types of external funds and securitizations that could be added to the list of exemptions from the Volcker Rule.

We don't yet know the final result of the proposals to weaken the existing Volcker Rule. Yet these proposals threaten to make the rule ineffective as a real limitation on bank activities. Indeed, reports from Wall Street are that traders who initially left bank trading desks for hedge funds are now returning, encouraged by reports of deregulation.[42]

---

[41] Colloquy of Senators Levin and Merkley, Congressional Record, July 15, 2010, p. S5894-S5899, available at http://graphics8.nytimes.com/packages/pdf/business/Economix-Merkley-Levin-Detailed.pdf

[42] Spezzati, Stefania, and Nishant Kumar, "Traders Who Left Banks for Hedge Funds Now Heading Back to Banks", Bloomberg News, June 29, 2017. https://www.bloomberg.com/news/articles/2017-06-29/traders-who-left-banks-for-hedge-funds-now-heading-back-to-banks

Looking Ahead: The Uncertain Prospects of the Volcker Rule

The history of the Volcker Rule has many important lessons, concerning both the bank business models that contributed to the financial crisis and to the resistance to changing those models. If forcefully implemented, the Volcker Rule has the potential to end the ability of banking organizations to engage in the kind of regulatory arbitrage and market manipulation that was drove the 2008 crisis. Due to the many exemptions and accommodations in the current Volcker rule, it is unlikely that it achieved this goal. The current rule does put some restrictions on the ability of banks to replicate the most dangerous elements of the proprietary trading business model. But a stronger version of the rule is called for to live up to the intent of its framers. Certainly there appears to be no case for weakening the rule. The changes now being proposed to the rule could weaken it to the point where its utility is questionable.

The justification for these changes is flawed. There is no clear evidence that the current rule has impacted market liquidity, certainly not to a level that should cause concern. Another claim is that the current rule is excessively complex and cumbersome. Yet much of this complexity results from the numerous exemptions and exceptions put in place in the 2013 rules in order to accommodate the banks' existing trading models. In other cases, complexity emerges from a compliance regime requiring produce metrics that measure overall trading activities. But many of these metrics should already have been collected regardless of the Volcker Rule as part of best practices for trading risk management. In fact, Oliver Wyman, a generally bank-friendly consultant, commented when the original 2013 Volcker Rule was finalized that banks should already be collecting either five or six of the seven currently required Volcker metrics as part of internal risk management for their trading desks.[43]

The 2018 proposed changes in the rule are supposedly motivated by a desire to simplify the rule. Yet many appear intended to weaken the rule, not simplify it. Some elements of the proposal introduce additional exemptions, a number of them complex, and others significantly increase the internal discretion of banks themselves to self-regulate and determine what the boundaries of the rule really are. This approach that makes it easier for banks to comply with the rule, but from the public perspective it makes the rule even more complex, in the sense that it is more difficult to understand what the rule is actually doing. Overall, it is unclear how the multi-hundred page proposal, which also includes hundreds of questions, would actually simplify the rule.

Should regulators wish to simplify the rule, there are ample opportunities to do so while making it stronger and more effective than it currently is. Eliminating complex exemptions currently in the rule would be one way to do so. For example, clear bright lines sharply limiting the buildup of bank trading inventories could be an effective mechanism for limiting proprietary trading

[43] Lester, John, Dylan Walsh and Lindsey Taylor, "The Volcker Rule: Reality", Oliver Wyman, December, 2013. https://owy.mn/2zNQ99z

while reducing the complexity of compliance. Stronger steps to entirely ban payment mechanisms that compensate traders based on trading profits would likely also be effective in driving proprietary trading out of the banking system without relying on complex definitions. This is an approach endorsed even by sharp critics of the existing rule.[44] Banks could even be limited to agency brokerage – a change that would make for a very simple rule but would eliminate the role of big banks as the central hubs of the capital markets.

While these and other alternatives could easily simplify the rule, they would significantly reduce bank trading activity. However, regulators value retaining this trading capacity, and value retaining it in the banking system. As they stated in the preamble to the final 2013 rule, "The Agencies understand that market makers play an important role in providing and maintaining liquidity throughout market cycles and that restricting market-making activity may result in reduced liquidity, with corresponding negative market impacts".[45] At every step, the rule and its implementation have been shaped by this regulatory reluctance to forcefully and meaningfully restrict bank trading. Even after passing a final rule that, as documented above, did not visibly reduce bank trading activity or have any significant effect on market liquidity, regulators are now proposing to weaken the rule still further.

This flies in the face of the Volcker Rule's intent. As Senators Merkley and Levin stated in their comment on the original Volcker regulations:[46]

> "One key objective of the Merkley-Levin Provisions is to stop proprietary trading and relationships with private funds by our banks. That objective necessarily means less trading by them. And while stopping proprietary trading and private fund investments by banks may temporarily impact some markets, we believe - and Congress determined - that the benefits of a safer financial system outweigh those potential impacts. Indeed, nowhere in the text of the statute nor in the legislative history of the provision is there any direction to regulators that the plain meaning of the statute should be ignored because of the potential impact it might have on the volume of trading in any given market. To the contrary, we and others intended for the Merkley-Levin Provisions to be a modem version of the Glass-Steagall Act."

[44] Bubb, Ryan and Kahan, Marcel, "Regulating Motivation: A New Perspective on the Volcker Rule", August 3, 2017. NYU Law and Economics Research Paper, Working Paper No. 17-27. https://ssrn.com/abstract=3016034

[45] "Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds", Final Rule, Federal Register, January 31, 2014. https://bit.ly/2JWVVMa

[46] Jeff Merkley and Carl Levin, "Comment Letter on Proposed Rule to Implement Prohibitions and Restrictions on Proprietary Trading", February 13, 2012. https://www.sec.gov/comments/s7-41-11/s74111-362.pdf

Regulators' attachment to a central capital markets role for banks is puzzling in light of the disastrous performance of this model in the 2008 crisis. Far from providing reliable through-the-cycle liquidity, dealers slashed their inventories of corporate bonds by 75 percent over 2008 as banks frantically rushed to sell off everything they could, in large part to fund trading losses.[47]

Regulators and other analysts of course admit that bank trading poses major risks and those risks have to be addressed in order to prevent the kind of economic catastrophe that occurred in 2008. But rather than forcefully restrict bank activities, they have instead proposed to intensify the reliance on capital and liquidity requirements to address the need for improved controls on market risk. But these kind of approaches failed prior to the 2008 crisis, in part due to the complexity of assessing the risks of vast trading operations involving millions of rapidly changing trading positions.

And the post-crisis record of regulatory initiatives to strengthen these requirements hardly inspires confidence. A decade after the crisis, the major international initiative by the international regulatory community designed to improve capital regulation of trading risks – the Fundamental Review of the Trading Book (FRTB) – has still not been implemented in the U.S. The FRTB has been continually revised at the international level to weaken its potential application, and the Trump Administration has proposed an indefinite delay in its U.S. implementation so it can be further "calibrated and assessed", stating that it would introduce "potentially unnecessary" new capital requirements.[48] Thus, regulators have been unable to properly implement even the technical reforms that they themselves admit would be necessary to better police bank trading. Regulators are also currently engaged in cutting other capital requirements, such as leverage ratio requirements.

The public and legislators should not simply stand by and watch as regulators fail to address the flawed business model that brought us the 2008 crisis. At a minimum, the Volcker Rule should be substantially strengthened and improved, not weakened. Controls on trading, external funds, trader compensation, and bank conflicts of interest should be reconsidered and made stronger, and public disclosure should be substantially improved. In the absence of these steps, Congress needs to act to put in place a sharper dividing between publicly insured banking and capital markets trading that allows for less regulatory discretion. The intent of the original Volcker Rule statute was a modernized form of Glass-Steagall. If regulators continue to thwart that promise, a return to a forceful statutory Glass-Steagall type division between banking and Wall Street trading would be the next step necessary.

---

[47] Table L 129 in Federal Reserve Flow of Funds, 2007-2009. Available at https://www.federalreserve.gov/releases/z1/20100311/z1.pdf. These broker-dealers include entities that were not bank holding companies in 2008 but are today.

[48] U.S. Department of the Treasury, "A Financial System That Creates Economic Opportunity: Banks and Credit Unions", June, 2017. https://bit.ly/2sVxOlt