

Comments on the Volcker Rule Activity Restrictions

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On January 21, 2010, President Obama announced the “Volcker Rule,” as an additional reform to his financial reform plan.¹ Under the Volcker rule, bank holding companies and financial services holding companies would “no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers.” The President indicated the rule is designed to prevent costly risks that could destabilize the banking system, preclude unfair advantages, and prevent conflicts of interest. This document discusses the rationale for the Volcker rule and suggests its effectiveness could be strengthened by supplementing it with traditional, simple, and proven regulatory rules, such as higher capital requirements and concentration limits on nonbanking activities.

How Volcker rule activities affect banks

The Volcker rule is based on the idea that banks have a special role in the financial system. They are integral to providing credit and operating the payment system. As a result, the failure of banking institutions can destabilize the financial system and damage the economy. This special role provides the justification for regulating bank and bank-related activities.

Some supporters of the Volcker rule have mistakenly claimed that restricting these activities is necessary because they cause bank losses directly or that banks use insured deposits to fund proprietary trading activities. However, these claims fail to distinguish between banks and holding companies that own banks. Specifically, Volcker rule activities can only be undertaken in holding company subsidiaries, and the Federal Reserve’s Regulation W places barriers between banking and holding company activities that would preclude, among other activities, using deposits to fund Volcker rule activities.

Although the Volcker rule activities do not affect banks directly, there are at least three channels through which losses due to these activities might affect a holding company’s bank indirectly. The channels exist because large holding companies manage activities along business lines that traverse legal entities.² The 3 channels are:

¹ The transcript is available at <http://www.whitehouse.gov/the-press-office/remarks-president-financial-reform>. In the same presentation, President Obama also proposed caps on the percentage of financial institution liabilities that could be held by any one firm to limit further consolidation in the financial system.

² For example, the investment banking business line at JPMorgan Chase, Citigroup, Bank of America all do underwriting, market making in securities and derivatives, and lending.

- Reputation effects – if a holding company's trading subsidiary fails, creditors may lose confidence in the holding company's bank. As a result, creditors could withdraw their funding from the bank.
- Withdrawal of customers that prefer a variety of services – holding companies are run along business lines (as opposed to legal entity lines) to more easily market to large customers that need a range of services. Failure of a holding company subsidiary may allow a large customer to be wooed away by a company that offers a full line of services. In such a case, the large customer may withdraw business and funding from the banking subsidiary.
- Funding from subsidiaries – A holding company's nonbank subsidiaries will deposit their funds and customers' idle balances in the bank. The failure of the nonbank subsidiary could cause a sudden withdrawal of a significant amount of funding. Due to reputation effects, the subsidiary's failure may make it difficult for the bank to raise replacement funding.

Risk, conflicts of interest, and expansion of the safety net

As noted above, banks play a special role in the economy because they provide financial intermediation services and are the critical component of the payments system. As the financial system has evolved, banking services also have evolved beyond the traditional services of lending and deposit taking to other financial intermediation and client service activities. These include such services as brokerage and market making, underwriting new issues of stocks and bonds, merger acquisition and advice, and investment advice. However, many large banking companies have gone beyond intermediation services to proprietary investment activities, which are the activities prohibited by the Volcker rule. These investment activities use the firm's capital to take greater financial risks that are expected to earn more attractive returns. With client service activities, transactions are undertaken for the firm's clients, while with Volcker rule activities, transactions are undertaken directly for the firm itself.

The proprietary investment activities not only tend to be riskier than client intermediation services, but when conducted with client activities in a single firm, they can cause conflicts of interest. For example, a firm that does client trading and proprietary trading has incentives to "front run" client trades. In addition, the financial system safety net (deposit insurance, discount window lending, etc.) has traditionally been provided for activities in the intermediation/client services category. Allowing a single firm to engage in both categories of activities extends the safety net's coverage. An important rationale for the Volcker rule is to prevent or reduce the potential for conflicts of interest and expansion of the safety net.

A modified Volcker rule proposal

The Volcker rule has many advantages. It prohibits holding companies from conducting risky activities that can lead to losses for subsidiary banks, create conflicts of interest, and expand coverage of the safety net. In addition, it reflects, in part, concerns that deregulatory efforts may have gone too far, allowing too much discretion and erring on the side of permissiveness. While the activities targeted by the Volcker rule were not a direct cause of the financial crisis, they contributed to the overall risk level in the financial system. Now that we have seen how destructive a financial crisis can be, many people are ready to be more restrictive. The Volcker rule can help ensure that the restricted activities are not the trigger that sets off the next financial crisis.

The Volcker rule should be strengthened, however, by supplementing it with traditional, simple, and proven regulatory rules, such as higher capital requirements and concentration limits, or additional supervision for nonbank holding company activities. Some critics have claimed that prohibiting proprietary trading would not be effective because it is difficult to distinguish from other trading and hedging activities. These critics argue that holding companies would simply continue to conduct these activities among other business lines, such as market making or prime brokerage, where the activity (and potentially the risks) are not as easy to identify and manage. Requiring these other activities to be conducted in separately capitalized subsidiaries subject to strict capital and concentration limits would strengthen the Volcker rule by offsetting such attempts to “hide” proprietary trading.

Providing regulators the authority to impose capital requirements and activity concentration limits on nonbanking subsidiaries would also reduce the amount of activities that need to be prohibited. Specifically, private equity investments do not create conflicts of interest and may not be significantly riskier than some activities that banks are allowed to conduct, such as leveraged lending. In addition, given that private equity firms are allowed to purchase banks, it seems inconsistent to prevent bank holding companies from making private equity investments. Strict capital requirements and concentration limits on private equity investments, therefore, may be sufficient to protect the financial system.

Conclusion

Conducting activities such as hedge fund sponsorship and investment and proprietary trading in a bank holding company can create problems for affiliated banks and the financial system. The activities have a risk profile that can lead to losses in affiliated banks, create conflicts of interests among various holding company business lines, and lead to an expansion of the safety net. The Volcker rule is a reasonable approach for controlling problems created by these activities, and it can be strengthened by allowing regulators to impose capital requirements and concentration limits on the nonbanking subsidiaries of holding companies.