

COMMENTARY ON THE RESTRICTIONS ON PROPRIETARY TRADING BY INSURED DEPOSITARY INSTITUTIONS

By Paul A. Volcker

Full discussion by the public, and particularly by directly affected institutions, on the proposed regulations implementing the Dodd-Frank Act, as with all proposed rules, is necessary and important. It is also true that the commentary and debate may generate uncertainty and confusion along with useful and needed improvements. That has been apparent in responses to the proposed regulation implementing certain restrictions on proprietary trading by commercial banking organizations – the so-called “Volcker Rule”.

In sorting out the problems – the real from the imaginary, the truly important from the incidental – the basic logic and approach of the law deserves re-emphasis.

The basic public policy set out by the Dodd-Frank legislation is clear: the continuing explicit and implicit support by the Federal government of commercial banking organizations can be justified only to the extent those institutions provide essential financial services. A stable and efficient payments mechanism, a safe depository for liquid assets, and the provision of credit to individuals, governments and business (particularly small and medium-sized businesses) clearly fall within that range of necessary services. Proprietary trading of financial instruments – essentially speculative in nature - engaged in primarily for the benefit of limited groups of highly paid employees and of stockholders does not justify the taxpayer subsidy implicit in routine access to Federal Reserve credit, deposit insurance or emergency support.

In fact, the comfort for creditors and others inherent in the ability of institutions engaged in proprietary trading to resort to the Federal “safety net” can only tend to encourage greater leverage and risk-taking. Commercial bank proprietary trading is thus at odds with the basic objectives of financial reforms: to reduce excessive risk, to reinforce prudential supervision, and to assure the continuity of essential services.

The questions and objections raised in comments on the proposed rules appear to fall into four broad categories:

1. Proprietary trading by commercial banks is not an important risk factor;
2. Needed liquidity in trading markets will be imperiled;
3. The competitive position of U.S. based commercial banking institutions will be adversely affected;
4. The proposed regulation is simply too complicated and costly.

My short answer to each of these objections is: “not so”. I will comment on each of them in turn.

THE RISK

On its face, proprietary trading entails substantial risks. It is essentially speculative in nature: securities are bought, held and sold in the expectation of profits from changes in market prices. The recent years of financial crisis have seen spectacular trading losses in large commercial and investment banks here and abroad operating on an international scale, with various loss estimates for major international commercial and investment banks ranging to hundreds of billions of dollars.

Demonstrably, internal controls are difficult to establish and to implement in active and highly complex markets. In critical instances they proved woefully inadequate. Consequently, the stability of important banks was jeopardized, contributing to a financial crisis of historic dimension.

The pressures on the big, American investment banks actively engaged in proprietary trading were the leading case in point. They required substantial government (i.e., taxpayer) assistance both before and more dramatically after the Lehman bankruptcy. Either directly or by merger with a commercial bank, the largest investment banks acquired a banking license, in effect being accorded the comfort of access to massive Federal Reserve and FDIC assistance.

To be sure, there were many factors other than proprietary trading contributing to the breakdown of financial markets. The speculative “bubble” in housing prices and the subsequent declines, excessive leverage by banks and other institutions (including the overuse and abuse of derivatives), inadequacies in accounting practices, and certainly the lack of regulatory oversight all contributed. Many of the losses within the thinly capitalized commercial banking system simply reflected weak underwriting practices. In that sense, proprietary trading, and the related activity of sponsorship and investment in hedge and equity funds, were not alone in causing the crisis. Many factors were involved. However, losses within large trading positions were in fact a contributing factor for some of our most systemically important institutions, and proprietary trading is not an essential commercial bank service that justifies taxpayer support.

The need to restrict proprietary trading is not only, or perhaps most importantly, a matter of the immediate market risks involved. It is the seemingly inevitable implication for the culture of the commercial banking institutions involved, manifested in the huge incentives to take risk inherent in the compensation practices for the traders. Can one group of employees be so richly rewarded, the traders, for essentially speculative, impersonal, short-term trading activities while professional commercial bankers providing essential commercial banking services to customers, and properly imbued with fiduciary values, be confined to a much more modest structure of compensation?

The result is to undermine the financial services industry as a service industry.

Complicating the situation further are the unavoidable conflicts of interest inherent in proprietary trading, particularly if embedded in market-making with the clear implication of fiduciary responsibilities toward customers. Institutional investors should be able to have confidence that their dealers are providing them the financial services they desire, for a transparent price, and are not operating at a conflict with their goals.

LIQUIDITY

As a general matter, efficient markets do need arrangements to facilitate trading in financial instruments. That ability to buy and sell large volumes of assets on short notice (termed “liquidity”¹) appeared, prior to the crisis, to be greatly enhanced. There should not, however, be a presumption that evermore market liquidity brings a public benefit.

At some point, great liquidity, or the perception of it, may itself encourage more speculative trading, even in longer-term instruments. Presumably conservative institutional investors are tempted to turn over positions much more rapidly, at the expense of careful analysis of basic values.

In the light of events, careful consideration of the benefits and possibly damaging consequences of increased liquidity has become the subject of new studies and commentary by economists and regulators. A consensus may be developing that beyond some point, little or no public benefit may be evident².

In any event, the restrictions on proprietary trading by commercial banks legislated by the Dodd-Frank Act are not at all likely to have an effect on liquidity inconsistent with the public interest.

The trading in stocks is still dominated by organized exchanges, and it is not the main focus of commercial bank trading activity. Trading in fixed-income securities and derivatives has become an important part of the activity of a few commercial banks over the past decade. Consequently, strong restrictions on proprietary trading (and on sponsorship of hedge and equity funds) under the new law present those institutions with a choice: give up either their proprietary trading activity or their banking license. The apparent reluctance to

¹ In most contexts, “liquidity” is defined as financial instruments that are inherently safe, short-term, and readily turned into cash with little risk of loss (i.e., Treasury Bills). “Market liquidity”, defined as the ease of trading any financial (or even non-financial) instrument, is more intangible, and depends upon the particular circumstances.

² See, for instance, lectures by Lord Adair Turner, Chairman of the U.K. Financial Services Agency entitled “What Do Banks Do, What Should They Do, And What Public Policies Are Needed To Ensure Best Results For The Real Economy”, 17 March 2010 and “Economics, Conventional Wisdom And Public Policy”, April 2010. Much earlier, in 1989, Lawrence and Victoria Summers wrote a prescient analysis, warning against excessive liquidity, concluding that the need for a Transaction Tax should be explored. In the 1930’s, John Maynard Keynes also questioned excessive emphasis on liquidity.

do the latter only reinforces the perceived value of access to the Federal safety net and the substantial implicit subsidy to borrowing costs.

In essence, proprietary trading activity, hedge funds, and equity holdings should stand on their own feet in the market place, not protected by access to bank capital, to the official safety nets, and to any presumption of public assistance as failure threatens. That, in essence, was the de facto distinction maintained until the last decade or two. Today, thousands of hedge funds operating with relatively little leverage and dependent on the equity capital of partners, represent much more limited risk to the financial system in the event of failure.

COMPETITION

The argument that United States banking organizations will suffer in their competitive position vis-à-vis international banks seems superficial at best, and more likely proprietary trading is counter to their prospects. Competition in banking, here as elsewhere, is desirable for the benefits it brings in institutional efficiency and better, more economical service to customers. Any contribution of proprietary trading to customer service and competition is not at all obvious. In fact, because of the risks, the conflicts of interest and the adverse cultural influence it may well impede effective competition.

Deposit and payment facilities, the providing of credit, and asset management – these are the substance of commercial bank customer services. Does anyone really think that institutions with highly leveraged proprietary trading will lure this business from solidly capitalized, U.S. banks focused on serving customers?

Restrictions on proprietary trading offer customers a “conflict of interest” free platform, with bankers focused exclusively on their customer’s needs and with all of the bank’s capital committed in support of those customer activities. Both underwriting and market making could continue alongside non-bank financial institutions. Consequently U.S. banks will remain able to compete effectively for the full range of a customer’s financial needs, and stand strongly against institutions preoccupied with purely proprietary interests.

COMPLEXITY

The complexity and potential costs of any rule-making in the world of modern finance presents a challenge. Enforcement of the restrictions required by the Volcker Rule is no exception. In approaching this problem, let us not lose sight of the fact that existing risk management practices of large financial institutions here and abroad, including some major U.S. commercial banks, fundamentally failed, at great cost to financial stability and the world economy. Hopefully, lessons have been learned. Both regulators and the regulated have been compelled to review previous practices, including various “metrics” to measure risk and to specifically control trading activity.

The regulators have released a “first draft”. They have provided ample opportunity for comment. As in other areas, judgments must be made about the balance between detailed

rules and a more principle-based approach – conceptualized as “Trust but Verify”³. Proprietary trading in any real volume is confined to a very few large, sophisticated U.S. banks: it has been reported that only six banks account for almost 93 percent of the trading revenue of all American banks. Purely proprietary activity is likely to have been even more concentrated.

CONCLUDING COMMENTS

In all their complexity, our giant banks are not easy institutions to manage. They need active leadership, an alert Board of Directors, internal controls, and even more a strong cultural tradition of “the customer comes first”. By their nature, they also have both large resources and a reservoir of management and technical talent.

The Federal regulators have enormous challenges of their own. They have also had a great learning experience, and have been tested beyond memory. Writing effective regulations to carry out all of the Dodd-Frank Act requires the best talent the regulating agencies have. And, at the end of the day, I feel confident that the restrictions imposed by the “Volcker Rule” can be reasonably and effectively administered.

With active cooperation among the agencies and with constructive consultation instead of futile stonewalling, an important reform can soon be put in place.

³ I deal with these matters in my comment letter more fully.