

COUNCIL *on* FOREIGN RELATIONS

Center for Geoeconomic Studies

POLICY INNOVATION MEMORANDUM NO. 18

Date: April 9, 2012
From: Benn Steil
Re: Beyond the Volcker Rule: A Better Approach to Financial Reform

THE ISSUE

An approach to bank regulatory reform that restricts the scope and incentives for bank balance-sheet expansion funded by short-term debt is essential to preventing another major financial crisis. Such regulation would have prevented the collapse of Bear Stearns in the United States or Northern Rock in the United Kingdom in 2008.

In curious contrast, a “Volcker rule”—a ban on proprietary trading by commercial banks—would have done nothing to mitigate the worst financial crisis since the Great Depression. Yet implementing such a rule has become a domestic and international political miasma that is draining credibility from the postcrisis regulatory reform process in the United States. The effort should be abandoned. To make the U.S. banking sector more resilient and less dependent on taxpayer support, hard constraints on bank leverage should be implemented: banks should be prohibited from expanding their assets beyond a certain level without increasing shareholder common equity proportionately. To address the problem that banks find equity capital more expensive than debt, the massive incentives for debt financing in the tax code should be diluted, or preferably eliminated.

THE PROBLEM WITH THE VOLCKER RULE

As formulated by former U.S. Federal Reserve chairman Paul Volcker, the Volcker rule is based on three beliefs: that proprietary trading is highly risky; that its economic benefits, beyond those flowing to “limited groups of highly paid employees and of stockholders,” are minimal; and that institutions engaged in such activities should not have access to a federal safety net in the form of Federal Deposit Insurance Corporation (FDIC) deposit insurance and other taxpayer-subsidized props. These beliefs are defensible to differing degrees. To the extent that they do constitute

compelling public policy concerns, however, the Volcker rule is not the best way to address them. It is unworkable in practice and does not speak to the fundamental problem of, or incentives driving, excessive bank risk taking.

Volcker argues that banks should choose to “give up either their proprietary trading activity or their banking license,” the latter of which provides them “access to the federal safety net,” including government-sponsored deposit insurance. Yet one clear lesson from 2008 is that the government will *on its own* extend that safety net to institutions with large proprietary trading businesses in a crisis—as it did with Goldman Sachs and Morgan Stanley. If a bank is too big to fail, it will continue to attract federal supports in a crisis. The only way to eliminate such supports is to eliminate the problem of too big to fail. This requires reforms of a character wholly different from a Volcker rule.

RISKY BUSINESS

The riskiness of proprietary trading depends entirely on the nature of the assets being traded, the trading strategy, and the leverage applied. The idea that proprietary trading is inherently riskier than traditional banking activities—transforming short-term liquid deposits into long-term illiquid loans—is surely false. The maturity mismatch between a bank’s deposits (its liabilities) and traditional loans (its assets) is itself a major source of risk to its solvency, one that is much smaller when the bank’s assets are liquid securities.

Banking under a Volcker rule is still a risky business. Banking without a Volcker rule may be more risky or less risky, depending on the specifics of the actual proprietary activities undertaken. Volcker rightly points out that proprietary trading “is essentially speculative in nature,” yet so is lending to commercial real estate ventures—a traditional banking activity.

In short, proprietary risk taking is the issue to be concerned with. Proprietary trading may not involve taking much risk, and proprietary risks can be large without much trading.

If a primary aim of the Volcker rule is to reduce the risk that deposit insurance funds will need to be used, a proprietary trading ban makes little sense. Policy can achieve this directly through so-called narrow banking rules—simply requiring banks to invest only in “safe” assets. The result would be the demise of credit provision by way of bank deposits, and a shift of such credit activity toward securities markets—the liquidity of which is necessarily sustained by speculative trading activity. There is no escaping this fact. The risk to depositors’ funds can only be systematically reduced at the expense of lower deposit yields and less credit provision by way of bank lending.

What the Volcker rule is actually getting at is not an evaluation of risk so much as a judgment on the relative societal benefits of lending versus proprietary trading. Yet the debate over the extent of legitimate carve-outs from the rule for “market making”—which has an important role in supporting the liquidity of debt markets—highlights just how blurry the boundary can be. It is thanks to securitized debt markets that many companies have been able to access cheap capital even in times when traditional banks—with impaired balance sheets from prior bad lending—have been retrenching.

The present regulatory effort to distinguish acceptable market-making activities and hedging from unacceptable proprietary trading—an effort hopelessly based on divining the “intent” of a given transaction—is a recipe for inflating compliance costs and encouraging new and wasteful forms of regulatory arbitrage. Since market making is a capital-intensive—that is, relatively costly—form of liquidity provision, there is no reason why policymakers should be privileging it in the first place. Automated trading in the equity and derivatives markets, for example, can often

supply market liquidity in the form of limit orders (that is, orders to buy or sell securities at a given price) at lower cost. The “intent” of the firm placing these orders is irrelevant. Such trading can also be less risky than market making.

The debate over the Volcker rule has necessarily taken on a major international dimension, as it directly affects foreign institutions operating in the United States and U.S. institutions whose market-making activities support government debt markets overseas. That the Dodd-Frank Act exempted U.S. Treasury and agency debt, but not foreign debt, from the Volcker rule has naturally rankled foreign governments. They cannot understand why the U.S. government only considers market making a worthy economic activity when it is directed at its own securities.

A BETTER WAY TO ENSURE FINANCIAL STABILITY

Plowing forward with the Volcker rule is not sensible. The rule does not get to the heart of the problem that fueled the financial crisis: excessive debt, particularly of the short-term variety.

A direct means of addressing the risks bank behavior can pose to financial stability is limiting their leverage, which invariably rises during booms—and reverses, with enormous collateral damage, during the subsequent busts. In the run-up to the financial crisis, large banks in both the United States and Europe financed a lending surge by rapidly expanding their non-deposit liabilities—that is, borrowing short-term using tools such as overnight repurchase (repo) agreements and financial commercial paper. The explosive growth of debt securitization (like asset-backed securities, mortgage-backed securities, and collateralized debt obligations) was fueled by parallel growth in the short-term bank borrowing necessary to fund it.

The United States needs to take two broad steps to constrain this process. The first is for the Fed to impose hard limits on the total assets a bank may acquire as a multiple of its common equity—what the shareholders themselves have at risk. This will restrict the ability of a bank to fund asset expansion through short-term borrowing, which increases its vulnerability to runs and sudden credit stops. This approach differs markedly from that of existing international bank capital regulation, enshrined in the so-called Basel rules, which applies an arbitrary risk weight to each of the bank’s assets based on a political judgment of how risky they are—a process through which Greek government debt emerged as “risk free.” The Basel approach considers reliance on funding through instruments such as reverse repos—the purchase of securities with the agreement to sell them at a higher price in the very near future—minimally risky simply because the credit risk is low. A leverage limit, in contrast, would recognize the risk to the bank’s solvency inherent in the volatile funding conditions in the wider market for this sort of short-term securitized lending.

Optimally, such a reform would be implemented globally, not just in the United States. American banks may complain of an unlevel playing field. But the twenty-five-year history of Basel regulation shows that implementation is so uneven across countries as to make this ambition more platonic than practical.

However, Congress could take an important second step that would mitigate the banks’ incentives to over-leverage in the first place: reducing the massive incentive for debt financing in the U.S. tax code. According to the Congressional Budget Office, U.S. corporations face an astounding 42-percentage-point effective tax rate penalty for equity-financed investments (36 percent) vis-à-vis debt-financed investments (-6 percent). This naturally encourages banks to operate at very high levels of leverage, and made them dangerously vulnerable financially as borrowing costs soared during the financial crisis.

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