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The Uncertain Dangers of the Volcker Rule

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The Volcker Rule is a major threat to the United States' preeminence in the financial sector. It must not be implemented in a way that disrupts market making by global universal banks.

There is a disturbing and neglected question at the heart of the controversy over the Volcker Rule's prohibition of proprietary trading at bank holding companies: are the prospective gains from these structural reforms worth risking the destruction of U.S. global universal banks and a significant decline in the U.S. share of global capital markets? The answer is obviously not.

The Volcker Rule is a major threat to banks' ability to continue acting as market makers (intermediaries that accept orders to buy and sell to maintain liquidity in the trading of particular financial instruments). Proprietary trading cannot be distinguished as an activity from market making. The two activities are not observably different on a transactional basis, but reflect different intent, which is not possible to observe.

Enforcement of the Rule that focuses on identifying proscribed activities inevitably would impinge on banks' market making. As economists recognize, that is a major problem; making global markets in financial instruments entails huge economies of scale, which means that global

universal banks have a unique role to play as market makers.¹ There simply aren't any other financial firms that are large enough to substitute for global universal banks as market makers.

What were global capital markets like before these transnational behemoths existed? Economist Ronald McKinnon's work on the problems of global capital markets in the 1970s — before the era of global universal banking, which was ushered in by London's Big Bang in 1986 and the deregulation of U.S. underwriting and branching limits in the 1980s and 1990s — is instructive. His book, *Money in International Exchange: The Convertible-Currency System*, bemoaned the consequences for market inefficiency of the lack of liquidity in foreign exchange markets. That book, and many other studies of the shortcomings of the capital markets of the 1970s, reminds us that markets didn't always function as well as they do now, and I, for one, do not want to return to that world of illiquid and inefficient markets.

The Threat to U.S. Banks and New York as a Financial Center

There is little risk of such a return to the past; if U.S. banks cannot make markets, European and Asian banks will fill the gap, and may do so by trading in *different* markets located outside the United States. This is not a far-fetched possibility. Some people who may be affected by the Volcker Rule's consequences for the efficiency of capital markets have warned about the risks that all countries bear from rigorous enforcement of that Rule. I'm not talking about statements by global universal bankers, but rather those of experienced economic policymakers at major central banks. For example, Mexico's Agustín Carstens, an economist and governor of the Bank of Mexico, has expressed great concern about the effects of the Volcker Rule on market liquidity, not only because of its effects on U.S. banks, but also because of its consequences for all banks with operations in the United States. In its effort not to disadvantage U.S. banks too much, the Volcker Rule covers all banks with operations in the United States. Because the Volcker Rule's net is so wide, the Bank of Mexico is concerned about the consequences for the liquidity of markets for Mexican sovereign debt and the peso, which depend on global universal banks as market makers. Mr. Carstens has concluded that because it is so far-reaching, the Volcker Rule would affect the Mexican banking system almost to the same extent as it would the United States'.²

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Unless regulators can find a way to avoid hobbling market making when prohibiting proprietary trading, it could turn out that the only way a global universal bank will be able to operate in Mexico and other countries is to stop operating in the United States — meaning not only ending its physical presence in the United States, but also moving its trading to other capital markets — a prospect that should worry Americans. The global market's ultimate adjustment to the Volcker Rule may be not only to shift resources to non-U.S. banks, but also to shun New York as a financial center and to move away from the dollar as a reserve currency.

Defusing the threat that the Volcker Rule poses for U.S. banking and capital markets is imperative. If we have to limit proprietary trading because of this ill-conceived Rule, then we

should make sure that we do so without hobbling market making. I like New York University Professor Matthew Richardson's proposal creating a safe harbor based on some simple rules limiting the size of securities inventories. A limit on inventories discourages proprietary trading (which requires significant holding periods on investments) but does little damage to market making because it does not require banks to hold securities for long periods of time. The simplest approach would be to impose a limit on the maximum ratio of securities holdings at any point in time relative to bank capital.

Shooting First, Asking Questions Later

But does it make sense even to limit proprietary trading by banks, using an effective safe harbor approach like the one proposed by Richardson? Many commentators say that proprietary trading is not a core activity of banks.³ That is a guess, not an informed opinion because there are no data and there is no academic study on which an informed opinion could be based. Guesswork by advocates of regulation about what is or isn't "core" has often been wrong. For example, the academic literature today supports the contention that the underwriting of clients' securities offerings and market making *are* core activities of global universal banks. In the case of underwriting, however, that perception wasn't the established view until the 1990s. As late as the 1980s, on the basis of faulty reasoning and the absence of serious research, many people argued that there was no good reason to combine underwriting and lending within the same bank, and many academics worried about substantial potential harm from doing so. A few years later, based on a large body of evidence, it became clear that there were significant benefits and no identifiable costs from combining lending and underwriting. The lesson that policymakers missed here is that it is dangerous to shoot first and ask questions later, as the United States did in its prohibition of mixing underwriting and lending in 1933.

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The social benefits of permitting global universal banks to engage in proprietary trading must be understood in the context of their relationships with clients. The Volcker Rule does not prohibit banks from structuring securities market hedges for their clients because there is wide recognition that designing and executing hedges is a central part of the bank-client relationship between global banks and global non-financial clients. If you are managing someone's underwriting, lending, and cash flow disbursements globally, it makes sense that you would also be the one to help that client measure its risks and design the right means to shed risks that they don't want to retain. Global universal banks are likely to be the most efficient providers of strategic outsourcing of risk analysis and management for global non-financial companies. Global banks do this by maintaining "client teams" that track the strategies of their clients and by constructing ad hoc "deal teams" as needed to manage the transactions that arise out of those multi-dimensional relationships. Deal teams design and execute hedges as part of those client relationships.

But what do these client-related synergies in hedging have to do with proprietary trading? To see the connection, consider this question: who is going to be sitting on the deal team that identifies

the need for a hedge and that constructs the right hedge for the client? Today, the people sitting on that team typically include finance professionals with substantial experience as traders. Some of them may even have designed some of the instruments that are being considered for hedging. Eliminating proprietary trading from a bank amounts to what I call the “Volcker Lobotomy”: it removes from the banking organization the human capital that is most capable of understanding financial instruments. When JP Morgan sits down with Hewlett-Packard or Shell to figure out how to do a very complicated global hedge, they want to rely on the advice of someone very smart, and that tends to be someone who designs and trades financial instruments for profit. Those people know how best to structure and execute an important transaction for a client.

Proprietary trading, therefore, may be part of the core activities of a bank because its existence within the bank ensures that the bank possesses the human capital needed to provide knowledgeable advice to clients about complicated transactions at crucial moments. Why can't outsiders do that for the client just as well? Because the client needs someone to provide a holistic analysis of its corporate finance strategy, which takes into account its corporate capital structure, its hedging strategies, and its cash flow management. It hopes to obtain such an analysis, and the execution of transactions that accompanies it, from its relationship with a global universal bank.

Don't misinterpret my observations as a claim that proprietary trading is a core activity of global banks. I'm not sure that it is, but I am sure that I am not alone in my ignorance: the evidence simply is not in on this question.

How big are the synergies among proprietary trading, hedging, and other activities? Some regard them as small. Perhaps they are. We don't know because no one has measured them. Doing so requires detailed data that are currently available only within banking organizations. Superficial evidence relating to London's Big Bang in 1986 tells us not to be too dismissive of the potential importance of these linkages. The Big Bang was primarily a reform of competition in securities dealing and brokerage, but it had other ramifications. Within five years of the Big Bang, the ratio of private bank credit to GDP tripled in the United Kingdom. It was one of the most amazing changes in bank credit that we've ever seen. Why did it happen? No one knows for sure, but it may be that synergies between lending and trading within global universal banks were part of the answer. What's striking to me is that we know very little about what drives value creation in the global universal banking model, which is so new. Don't misinterpret my observations as a claim that proprietary trading is a core activity of global banks. I'm not sure that it is, but I am sure that I am not alone in my ignorance: the evidence simply is not in on this question.

Four years ago, I began a research project to investigate activity synergies within global universal banks (which I undertook with no financial support of any kind from the subject bank, for obvious reasons). When Dodd-Frank was passed, the bank that had allowed me to begin that study — presumably because it believed that I would find large synergies — decided that there was no longer enough upside for them to make it worth their while to grant me such unprecedented access to highly sensitive data. Ironically, Dodd-Frank's shoot first and ask questions later approach put an end to the only attempt underway at that time to measure the size of client-based synergies related to trading, hedging, and other services, which would have

helped us gauge the extent to which proprietary trading is a core activity of global universal banks.

Now, one might argue that despite our ignorance, we cannot afford to wait to assemble the evidence; if there were extreme “systemic risks” clearly associated with proprietary trading, then one might be able to justify the shoot first and ask questions later approach. But there is no good reason to believe that proprietary trading contributes to systemic risk. Clearly, we learned during the recent banking crisis that if banks want to suddenly undertake a large amount of mortgage lending risk, they can do so through lending to risky borrowers. Prohibiting proprietary trading won’t prevent too-big-to-fail banks from taking on excessive risks in mortgage lending or other lending, or from being bailed out when they do.

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The recent crisis isn’t the only example of the connection between risky lending and systemic risk. Remember that, in the United States, too big to fail got a big boost in the 1980s with the bailout of an energy lender named Continental Illinois at a time when many banks and thrifts with exposure to energy loans were failing. Continental operated only a handful of branches in Chicago; by current standards, it would not be considered a large bank, and certainly not a global universal bank. Paul Volcker, ironically, was the person who pushed for the bailout of Continental Illinois, incorrectly arguing that its failure might jeopardize many other banks (in fact, deposits of other banks in Continental generally were small enough to be fully covered by deposit insurance, as critics of the bailout noted at the time). The precedent of bailing out Continental was particularly damaging because it was so small and unimportant: if we couldn’t muster the courage in our regulatory community to allow a bank like Continental to go bust, then it was clear that we were going to bail out just about everybody.

No, the Volcker Rule is not going to prevent systemic threats due to risk taking by banks, or solve the too-big-to-fail problem. It has no identifiable benefits of any significance and large potential social costs. It could hobble U.S. banks’ market making, and more broadly, make them non-viable global competitors. It could threaten the use of U.S. capital markets as a place to issue and trade securities. Furthermore, even if the Rule were crafted to prohibit proprietary trading narrowly without interfering with market making, that could entail further hard-to-estimate costs to the extent that proprietary trading is an important activity to preserve within global universal banks.

From Glass to Volcker

How did we get into the current mess over the Volcker Rule? It was passed quickly, as part of the hurried consideration of Dodd-Frank, with little evidence for its potential benefits and even less discussion of its potential costs, based on the advocacy of Paul Volcker. To those familiar with the 1930s banking legislation, Mr. Volcker’s role here was remarkably similar to that of Carter Glass in 1933. Senator Glass had a strong ideological antipathy to mixing commercial and

investment banking and had been trying to limit the activities of commercial banks for more than two decades (based on a theory of credit called the “real bills doctrine” — a theory that currently has no adherents). Glass got his opportunity in 1933, when he used a logrolling strategy to incorporate his prohibition into the far-reaching banking regulation of 1933. His success did not reflect any connection between the securities underwriting activities of banks and the banking crises of the Great Depression. On the contrary, all of the academic literature on commercial bank involvement in underwriting (written in the 1980s and 1990s) shows that commercial banks’ involvement in underwriting in the 1920s and early 1930s was beneficial; it reduced the risk of bank failure and provided valuable services for clients.

Even the successful construction of a regulatory safe harbor that insulates market making from the Rule may place U.S. banks at a significant comparative disadvantage and result in substantial losses of client relationships to universal banks operating outside the United States.

Glass was able to get his way by using the “findings” of the 1932 Pecora Hearings — and the public animus toward large banks in reaction to those hearings — to justify taking aggressive action against the big commercial banks.⁴ Similarly, Mr. Volcker finally got his chance to turn back the clock after the 2007-2009 crisis because of an atmosphere that was extremely hostile to large banks. It is worth noting that, if it had been up to Mr. Volcker, we never would have allowed Glass-Steagall underwriting prohibitions to be relaxed in the 1980s and 1990s. If he had his way in the 1980s, we wouldn’t be agreeing today about how obvious it is that underwriting should be viewed as a core activity of commercial banks, because we never would have had the benefit of seeing how useful it is to permit commercial banks to be underwriters. Our regulators would still be confidently, and wrongly, assuming that underwriting was not part of the “core” function of large banks.

The Volcker Rule is a serious threat to the continuing global preeminence of U.S. banks and capital markets. It will achieve little or no good, and will do so at a potentially high social cost. At the very least, we need to make sure that the Rule is implemented in a way that does not disrupt market making by global universal banks. Even the successful construction of a regulatory safe harbor that insulates market making from the Rule may place U.S. banks at a significant comparative disadvantage and result in substantial losses of client relationships to universal banks operating outside the United States. The Volcker Rule highlights the dangerous tendency of Washington, and its coterie of anointed wise men, to react boldly to crises based on superstition or ill-informed beliefs.

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