



The Volcker Rule: Liquidity and Other *Myths* Used to Carry Water for the Big Banks

The Dodd-Frank Act's Volcker Rule prohibits big banks from engaging in proprietary ("prop") trading, which is short-term, speculative trading without a socially useful purpose.¹ Those big banks subject to the Volcker Rule benefit from taxpayer-backed deposit insurance, meaning prop trading can ultimately become the responsibility of the taxpayers when it results in significant losses, as was the case in the 2008 crisis.

The big banks have a "heads we win, tails you lose" proposition: When their speculative bets are profitable, executives receive huge bonuses; when the bets go bad, taxpayers must step in to prevent losses to depositors. The critical role big banks play in the payments system and the interconnectedness of financial markets all but ensure government bailouts will follow if prop trading losses threaten big banks' stability.

By prohibiting speculative trading, the Volcker Rule prevents the types of trading losses that make bailouts more likely and reorients big bank activities to socially useful lending that benefits the real economy - such as starting a business or buying a home - that ought to be supported by taxpayer-backing.

Big banks ruthlessly pursue returns for shareholders and are run by executives whose higher bonuses are directly conditional on those returns for shareholders. Too frequently, these incentives push managers to chase short-term, speculative bets. The Volcker Rule therefore threatens both shareholder earnings and managers' bonuses. And so, it is no surprise that big banks have launched an all-out attack on the Rule, spreading misinformation which this paper will debunk.

Paul Volcker, Former Chairman of the Federal Reserve, summarized the problem of prop trading concisely:

"[T]here has been, and remains, a strong public interest in providing a "safety net" - in particular, deposit insurance and the provision of liquidity in emergencies - for commercial banks carrying out essential services. There is not, however, a similar rationale for public funds - taxpayer funds - protecting and supporting essentially proprietary and speculative activities. . . A number of the most prominent [investment banks], each heavily engaged in trading and other proprietary activity, failed or were forced into publicly-assisted mergers under the pressure of the crisis. It also became necessary to provide public support via the Federal Reserve, the Federal Deposit Insurance Corporation, or the Treasury to the largest remaining American investment banks."²

We must avoid the types of severe crashes that send markets reeling and set tens of millions of Americans back by years. That means avoiding the risky gambling that helped cause the 2008 crisis in the first place.

The Volcker Rule reasonably constrains the rapacious, bonus-focused culture on Wall Street that encourages socially useless trading with little if any benefit to the real economy. The Volcker Rule therefore must be maintained and strengthened, not rolled back due to Wall Street's self-serving, specious arguments. What follows are four of those misleading arguments, and the data that disprove them.

¹ Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat.1376 (July 21, 2010) ("Dodd-Frank" or the "Act"); Section 13 of the Bank Holding Company Act ("BHC Act"), 12 U.S.C. § 1851.

² Paul Volcker, Statement of Paul A. Volcker, Prohibiting Certain High-Risk Investment Activities by Banks And Bank Holding Companies: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 111th Cong. 49, at 1-2 (Feb. 2, 2010).

Bogus Big Bank Argument #1

“The Volcker Rule hurts liquidity by restricting market-making in the capital markets.”



Reality: There is virtually no evidence the Volcker Rule has impaired market liquidity, and independent studies show liquidity has improved since adoption of the Volcker Rule.

These studies and many others disprove the big banking industry’s self-serving claims about the Rule’s impacts:

- The Treasury Department in 2016 examined corporate bond market liquidity and concluded the “available data does not show convincing broad-based evidence of dwindling liquidity.”³
- A 2017 report by the Securities and Exchange Commission found no evidence to support the assertion that the Volcker Rule had impaired liquidity in corporate bond and U.S. treasury markets.⁴
- The Chief Economist of the Financial Industry Regulatory Authority (FINRA) in 2015 examined more than a decade of transaction data for corporate bonds and concluded: “Some industry participants have become alarmed about the decline in liquidity in the corporate bond market.... [T]here does not appear to be strong evidence to support this view. New issuance is strong, secondary market trading volume continues to rise and bid-ask spreads continue to fall.”⁵
- The Federal Reserve Bank of New York concluded that “[o]verall, we do not find strong quantitative evidence of a widespread deterioration in bond market liquidity in the years after the crisis.”⁶

These findings are supported by independent academic studies, which have found that “[P]rice-based liquidity metrics improve after the crisis and are better in 2013-2014, when more reforms are implemented, than before the crisis,”⁷ and that there is “[N]o significant liquidity deterioration in the period of regulatory intervention covering the approval of the Dodd-Frank Act and Basel III, shutdowns of proprietary trading desks by major banks, or the proposal and finalization of the Volcker Rule.”⁸

Finally, there is no greater threat to market liquidity than another financial crisis. Proprietary trading and poor risk controls contributed to the banking crisis of 2008 because it brought securitization markets to a halt, reduced liquidity, impeded lending and capital formation, and diminished job creation and economic growth. Proprietary trading liquidity, as it turned out, was illusory and exacerbated the crisis. Consequently, the Volcker Rule is one critical measure that protects the liquidity of the U.S. financial system.

³ Jake Liebschutz and Brian Smith, Examining Corporate Bond Liquidity and Market Structure (July 7, 2016), available at <https://www.treasury.gov/connect/blog/Pages/Examining-Corporate-Bond-Liquidity-and-Market-Structure.aspx>.

⁵ Bruce Mizrach, FINRA Office of the Chief Economist, Research Note, Analysis of Corporate Bond Liquidity, available at https://www.finra.org/sites/default/files/OCE_researchnote_liquidity_2015_12.pdf.

⁶ Tobias Adrian, Michael Fleming, Or Shachar, and Erik Vogt, Market Liquidity after the Financial Crisis, Federal Reserve Bank of New York Staff Reports, Staff Report No. 796 (October 2016), available at https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr796.pdf?la=en.

⁷ Mike Anderson, Rene M. Stulz, Is Post-Crisis Bond Liquidity Lower?, National Bureau of Economic Research, Working Paper 23317, 1, 28 (2017), available at <https://www.nber.org/papers/w23317.pdf>.

⁸ Francesco Trebbi and Kairong Xiao, Regulation and Market Liquidity, 1, 30 (May 27, 2016), available at <http://faculty.arts.ubc.ca/ftrebbi/research/tx.pdf>.



“The Volcker Rule is too complex for the Big Banks to implement.”

Reality: The Volcker Rule is a narrow prohibition on proprietary trading made complex through the efforts of the big banks themselves, who lobbied for many of the complexities in the Volcker Rule.

The final version of the Volcker Rule included in the Dodd-Frank Act was nearly four times the length of the original amendment offered by Senators Merkley and Levin, and grew in length and complexity due to a sustained lobbying effort by the big banks intended to undermine the Volcker Rule effectiveness.⁹ If the Volcker Rule is complex, in other words, it is because the big banks fought to make it so. For the big banks to now complain about the Rule’s complexity is like the son who gets convicted for killing his parents but pleads for leniency because he is an orphan.

The Volcker Rule’s requirements for risk management, compliance, and controls are achievable with the banking industry’s existing frameworks and best practices, which big banks have implemented and maintained for years. Big banks therefore already should have had risk management, compliance, and controls frameworks in place that could be adapted to the Volcker Rule’s requirements.

It’s also the case that the “complexity” of the Volcker Rule was once welcomed by big banks, who saw it as an alternative to even broader reform of the U.S. financial system. It would have been far simpler to rein in proprietary trading by reinstating the Glass-Steagall ban on the affiliation of investment and commercial big banks. Indeed, former Federal Deposit Insurance Corporation Chair, Sheila Bair, has suggested as much:

“FDIC insured banks and their affiliates should make money by providing credit intermediation and related services to their customers, not by speculating on market movements with the firm’s funds. . . I fear that the recently proposed regulation to implement the Volcker Rule is extraordinarily complex . . . Complex rules are easy to game and difficult to enforce. We have too much complexity in the financial system already. If regulators can’t make this work, then maybe we should return to Glass-Steagall in all of its 32-page simplicity.”¹⁰

If big banks find the Volcker Rule too complex to implement, perhaps a simple separation of investment and commercial banking would be a better solution. Or perhaps the U.S. should follow other jurisdictions that have opted for different solutions or focus on compensation practices that reward complexity.¹¹

⁹ For additional information on the legislative history of the Volcker Rule, see Senator Jeff Merkley and Senator Carl Levin, Policy Essay: The Dodd-Frank Act Restrictions on Proprietary Trading and Conflicts of Interest: New Tools to Address Evolving Threats, 48 Harvard Journal on Legislation 515 (2011), available at http://harvardjole.wengine.com/wp-content/uploads/2013/10/Merkley-Levin_Policy_Essay1.pdf. See also Protect Our Recovery Through Oversight of Proprietary Trading Act of 2010 (PROP Trading Act), S. 3098, 111th Congress (2010).

¹⁰ Testimony of Sheila C. Bair before the Senate Committee on Banking, Housing and Urban Affairs Financial Institutions and Consumer Protection Subcommittee, “A New Regime for Regulating Large, Complex Financial Institutions” (December 7, 2011), available at <https://www.banking.senate.gov/imo/media/doc/BairTestimony12711.pdf>.

¹¹ Such as ring-fencing rules for retail banking in the United Kingdom, which restrict inter-affiliate funding and other activities that increase connectivity between functions of large financial institutions because “[p]roprietary trading, in particular, is not a necessary part of intermediation in the real economy and so should not be conducted in the same entity as the mandated [retail banking] services.” Independent Commission on Banking, 45, available at <http://webarchive.nationalarchives.gov.uk/20131003105424/https://hmtsanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf>



“Proprietary trading didn’t cause the financial crisis.”

Reality: Proprietary trading resulted in hundreds of billions of dollars of losses leading up to and during the 2008 financial crisis. Big bank trading in complex, speculative investments – particularly mortgage-backed securities - caused significant losses to most of the major big banks that failed during the crisis. *Time* reporter Stephen Gandel summarized the scale of the losses:

Lehman lost more than \$32 billion from proprietary trading and principal transactions during the year and a half leading up to the financial crisis and [in two years] since . . . And Lehman wasn’t alone. Merrill Lynch lost nearly \$20 billion on investments in collateralized debt obligations (CDOs). Morgan Stanley had a nearly \$4 billion loss in proprietary trading in the fourth quarter of 2007. Goldman Sachs spent \$3 billion to bail out one of its hedge funds. And Citigroup.... lost big - as much as \$15 billion, on the CDOs it decided to hold rather than sell off. In fact, nearly every large financial firm that stumbled during the financial crisis had billions of dollars in proprietary-trading or hedge-fund losses.¹²

By the end of the financial crisis, the total proprietary trading losses would dwarf even those figures. Losses of this magnitude not only affect the safety and soundness of taxpayer-backed big banks but tend to correlate with other big losses. In other words, they arise from stresses that spur other types of losses and occur at precisely the time when the big bank is most in need of capital reserves.

Consider the single largest trading loss at a large bank: Shortly prior to the 2008 crisis, Morgan Stanley lost approximately \$9 billion subprime mortgage bets. The bank’s losses in other areas mounted, just as the firm took huge losses from these positions, and prop trading produced losses at the very time that the firm could least afford them. Morgan Stanley was not alone. Citigroup, for example, also took huge losses on prop trades linked to mortgage-backed securities. By the end of 2008, Citigroup had written off \$38.8 billion on these and other assets, losses which put the company on the brink of failure and led to a federal bailout.¹³ Prop trading losses were only one component of Citi’s woes during the financial crisis, but they worsened an already dire situation created by its poor credit decisions and poor risk management.

The near-collapse of Citigroup is illustrative of the harm that prop trading can cause throughout the financial industry. And yet, every major Wall Street financial institution was involved in some type of prop trading in the lead up to and during the 2008 financial crisis. Many would have almost certainly failed but for massive emergency bailouts provided by the American taxpayer to resolve their failed bets.

Prop trading continued long after the 2008 crisis. In the “London Whale” episode, J.P. Morgan Chase realized a loss of at least \$6.2 billion dollars primarily from prop trading involving credit derivatives.¹⁴ Coming several years after the 2008 crisis, these losses were not an existential threat to the firm. But had they occurred in 2007-08 when the trading strategy was first implemented, however, they would have been far more devastating and could have plunged the bank into insolvency.

¹² Stephen Gandel, Is Proprietary Trading Too Wild for Wall Street (Feb. 5, 2010), available at <http://content.time.com/time/business/article/0,8599,1960565,00.html>.

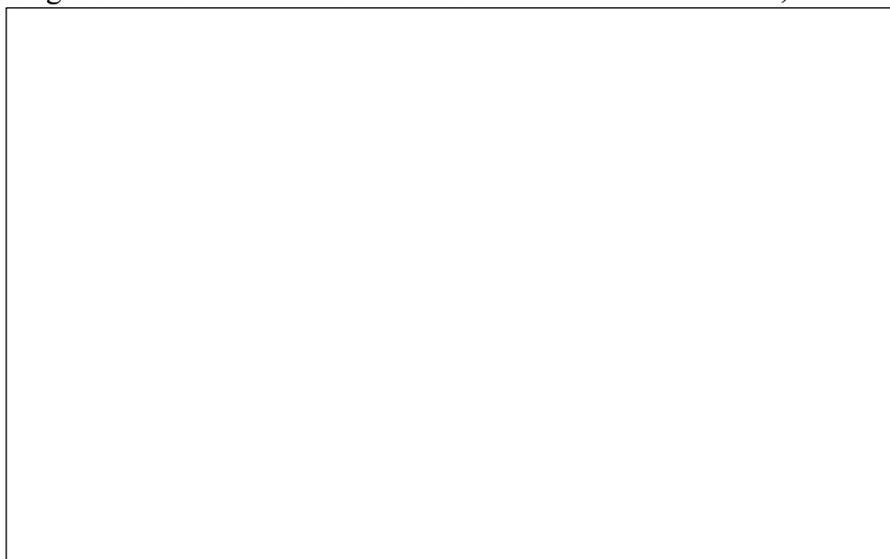
¹³ See Special Inspector General for the Troubled Asset Relief Program (2011). Extraordinary Financial Assistance Provided to Citigroup, Inc., January 13.

¹⁴ JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses, United States Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, 1 (April 11, 2013), available at [https://www.hsgac.senate.gov/imo/media/doc/REPORT%20-%20JPMorgan%20Chase%20Whale%20Trades%20\(4-12-13\).pdf](https://www.hsgac.senate.gov/imo/media/doc/REPORT%20-%20JPMorgan%20Chase%20Whale%20Trades%20(4-12-13).pdf).



“The Volcker Rule will make it difficult for the big U.S. banks to compete globally.”

Reality: There is zero evidence the Volcker Rule has hurt the competitiveness of the big U.S. banks, which dominate markets globally. Return-on-equity, income, and profits are at historic levels. The largest banks reported \$44 billion in trading revenue during the first half 2018, with Goldman Sachs and J.P. Morgan posting 24% and 13% increases, “on track for the best year since 2011.”¹⁵ And returns-on-average-equity for mid to large banks has increased since the start of the Volcker Rule, as the data show:

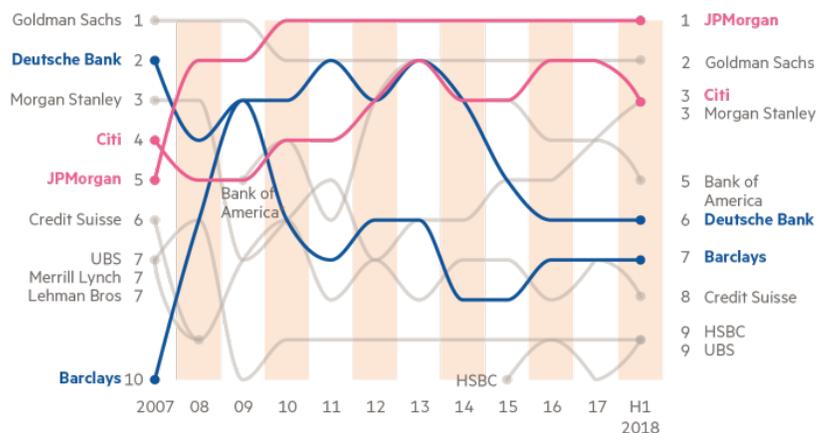


Data Source: Federal Reserve Bank of St. Louis

As well, the big U.S. banks dominate globally:

Goldman Sachs moves above Citi in investment bank rankings

Coalition ranking (1 = best)



* Bank of America rankings are only included from 2009, after the BofA-Merrill Lynch merger
 Source: Coalition
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In short, we find no verifiable data that demonstrate the big U.S. banks have lost ground by the Volcker Rule.

¹⁵ Matt Scuffham, Rishika Dugyala, Wall Street traders set for best year since aftermath of crisis, (July 18, 2018), available at <https://www.reuters.com/article/us-usa-banks-results-trading/wall-street-traders-set-for-best-year-since-aftermath-of-crisis-idUSKBN1K8211>.