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Volcker Rule: Swiss-Cheesed or Beefed Up?

When President Obama's fortunes were tanking in the winter of 2010, he needed a way to come out punching at the bankers again in order to gain some more momentum on financial reform – and with the voters. So he turned to an unlikely "populist" symbol – Paul Volcker, former head of the Federal Reserve System from the 1980s, who had been widely reviled, especially on the left, for his anti-inflationary crusade and high interest rate policy at that time. Volcker's policy raised unemployment to dizzying heights, resulted in thousands of bankruptcies, and ushered in the Third World debt crisis that left much of South America in economic ruin for a decade or more. But as a sign of how crazy US politics had become and how far economic discourse had shifted to the right in the ensuing 30 years, Paul Volcker had become a voice of relative sanity in the fight over financial reform in the wake of the Great Financial Crisis of 2007-2008. Obama called a press conference with Volcker at the front and Timothy Geithner, Obama's Treasury Secretary who had been very unenthusiastic about significant financial reform, slightly behind and with a scowl on his face. The conference announced Obama's support for "the Volcker Rule", which was to be included in the Dodd-Frank Financial Reform bill that was under development and the subject of furious debate in Washington – and that ultimately became law in the summer of 2010.

The problem with the Dodd-Frank bill is that it passed along responsibility for the complex "rule-making" process to five federal regulators, who were tasked with writing the fine details governing the implementation of the financial reform law. By design on the part of the banks, this rule-making process gave the Wall Street lobby an open playing field to obstruct, gut and re-write the financial reform. Consequently, it was not until December 2013, a full year after the original deadline, that the actual detailed wording of the Volcker Rule was finalized. Moreover, most of it will not be implemented until 2015 or 2016, six years after passage of the Dodd-Frank legislation. Why so much time? The answer: the banks hate the Volcker Rule and have invested millions of dollars in lobbying and buying off politicians and their staff members to delay and water down the measure. This presents us with an important question: Had the rule been so thoroughly Swiss-cheesed by the banks that it had too many holes to be of any value? Or does it still have enough substance to make the financial system safer and more socially productive?

The Volcker Rule, whose details were developed by Democratic Senators Jeff Merkeley of Oregon and Carl Levin of Michigan, called for an end to "proprietary trading" by banks that had access to taxpayer bailout funds if they got into trouble. Proprietary trading is defined as activities in which banks put their own capital at risk to profit from changes in asset prices and movements in interest rate spreads, rather than from interest or fees from providing services for their customers. The logic behind the Rule is that if financial institutions want to engage in risky, speculative activities, they should not put taxpayer resources at risk. Those activities should be left to hedge funds and other similar institutions, leaving banks to engage in activities that are socially beneficial, such as providing useful credit to businesses, households and governments.

The Rule also called for strict regulations to end conflicts of interest between these banks and their customers, such as had occurred in the run-up to the crisis when Goldman Sachs sold complex securities to customers – even though it knew that they were likely to crash in value – while at the same time taking out large bets that these securities would fail, without informing their customers that they had done so. Such conflicted activities were part and parcel of the highly complex and risky deals that the large banks engaged in that greatly contributed to the financial crisis and that the Volcker Rule was designed to prevent. In short, the Volcker Rule was meant to separate boring banking supported by taxpayer safety nets from highly risky and speculative banking that, in theory, had no such support: a sort of "Glass-Steagall lite".

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But even as the Dodd-Frank wording was still being developed, the banking lobby sprang into action. They were able to get importance exceptions written into the law for “market making” and “hedging”. In the ensuing battle, the tireless defenders of the Volcker Rule, including Sens. Merkely and Levin as well as poorly funded public interest groups such as Americans for Financial Reform (AFR), Better Markets, and Occupy the SEC, tried to keep these exceptions as narrow as possible, while the bankers tried to blast them open as far as they possibly could.

In terms of market making, the banks argued that they needed to have holdings of securities on their books in order to have them available to sell to (and buy from) their customers. If they did not accumulate these securities, then they could not provide needed liquidity to their customers and this would harm financial markets and the economy. The Merkely-Levin write-up of the Volcker Rule allowed banks to hold inventories based on the expected short-term demand of their customers, which should have been adequate to provide the needed liquidity. This issue of defining market making was of great interest to the banks. Writers at Bloomberg estimate that market making provides more than $ 40 billion a year in revenue to the Wall Street banks.

Defining hedging, the second exception, was also crucial. Banks could claim that their holding of risky securities were simply designed to hedge or offset some other position that the bank had to take on behalf of customers, so as to reduce the overall risk assumed by the bank. In other words, they could hide massive amounts of proprietary investments by the bank, claiming they were simply hedges. And in fact, the banks were winning this fight until the JP Morgan London Whale scandal broke in 2012, in which JP Morgan lost over $6 billion engaging in risky proprietary bets that they claimed were “hedges”. At this point, the regulators were forced to take a tougher stance on hedging by defining it more narrowly and requiring more documentation in order to limit proprietary trading masquerading as “portfolio hedging”. In the final rule, banks are required to match their holdings closely with the positions they are hedging and also to report data to regulators on these positions on a timely basis. Furthermore, the rule requires the CEOs of the banks to attest that their bank has a framework in place to identify and prevent proprietary trading. This language was watered down from what Paul Volcker had suggested, namely that CEOs should verify that no illegal proprietary trading was taking place, period. Another key feature of the final language reflected the understanding that unless incentives at Wall Street banks are changed, no amount of verbiage will prevent illegal proprietary trading from taking place. Accordingly, the final language prohibits traders from receiving payments based on profits from illegal proprietary trading.

Still, the vast amounts of money the banks put into lobbying paid off handsomely in other respects. The bankers organized European politicians to fight against Volcker prohibitions on the proprietary holding of sovereign debt and strict regulations on foreign-based subsidiaries of banks with activities in the US. These resulted in some key exemptions on proprietary trading in certain assets and for certain foreign-related banking entities. The banks were also able to broaden the rules to some extent that allow them to invest in hedge funds. Still, many of the large Wall Street banks have been spinning off hedge fund operations in order to create a bit more distance between themselves and these funds.

So what is the ultimate verdict on the battle over the Volcker Rule? It is still too soon to tell. While many press reports claimed that the rule passed by the regulators in December was “much tougher” than had been expected, Goldman Sachs saw its stock price actually climb by 1.2 percent on the day the new rules were announced. Of course, this is not the end of the fight. Much of the interpretation and enforcement of the rules was left to the regulators. And the banks, which have already threatened to sue the regulators over aspects of implementation, will continue to lobby as long as they can. The supporters of financial reform, such as AFR, Better Markets, and some key regulators, will need a lot of help from citizens to keep these issues on the front burner and to remain vigilant. You can bet that the bankers will.