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Commentary on the Volcker Rule

On July 21, 2010 President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. It represents the most comprehensive and sweeping financial regulatory reform measures taken since the Great Depression. The *Volcker Rule* (proposed by former Federal Reserve Chairman Paul Volcker) is a specific section of the Dodd-Frank Act that prohibits a bank, or institution that owns a bank, from engaging in proprietary trading that may not be in the best interests of its clients, and from owning or investing in a hedge fund or private equity fund, as well as limiting the liabilities that the largest banks can hold. This will help to draw a clear distinction between commercial banks and investment banks. The provisions of this rule are premised on the belief that the speculative trading activities of many banks contributed in large part to the financial crisis of 2008-2009. The Volcker Rule is the first cousin to the Glass-Steagall Act of 1933, although Glass-Steagall was much more comprehensive.

The Glass-Steagall Act was in direct response to the Great Depression and the collapse of the U.S. commercial banking system during the 1930s. The act introduced the separation of the bank types according to their business – *commercial and investment banking*. In the early 20th century, bankers and brokers were sometimes indistinguishable. After the stock market crash of 1929, and the subsequent economic depression, members of Congress and many economists began to examine the mixing of the “commercial” and “investment” banking industries that occurred in the 1920s. The barrier between commercial banks and investment banks had become very blurred. Congressional hearings revealed conflicts of interest and fraud in some banking institutions’ securities activities. Stated in plain English – it was decided that commercial banks should be restricted from using depositors’ money to engage in speculative proprietary trading for their own accounts, and there needed to be a clear division between banks that accepted customer deposits (commercial banks) and banks that issued securities (investment banks). The idea was to give government regulators the ability to distinguish between the two entities, and therefore monitor their business activities more effectively. Does any of this sound familiar?

The Glass-Steagall Act was ultimately repealed in 1999, following mounting pressure from banking industry lobbyists and politicians on both sides of the isle. Almost overnight, the line between commercial banks and investment banks was virtually invisible. To be sure, companies like Goldman Sachs and Lehman Brothers were always known as the big “Wall Street” investment banks. But after the repeal of Glass-Steagall, commercial banks like Bank of America and Washington Mutual engaged in much of the same activities that

were once only associated with Wall Street investment banks, such as proprietary trading and brokerage services. The average customer didn't particularly care or even realize that their bank was engaged in these activities with depositors' funds, or that there bank may have even owned an investment bank. Many proponents of the Glass-Steagall Act point to its repeal in 1999 as setting the stage for the financial meltdown just a decade later.

Since the financial crisis of 2008-2009, the investment banking industry as we've come to know it has all but disappeared. At the start of 2008, Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns were the five largest stand-alone investment banks. These five companies had existed for a combined total of 550 years, and were the only players that really mattered on Wall Street. Within a span of six months: Bear Stearns sold to J.P. Morgan for next to nothing, Merrill Lynch sold to Bank of America just to survive, and Lehman Brothers filed for bankruptcy. The only two remaining independent investment banks were Goldman Sachs and Morgan Stanley. As the financial crisis worsened it became apparent that even the two most prestigious Wall Street investment banks could not survive in their current state. Goldman Sachs and Morgan Stanley were forced to convert to bank holding companies. By converting to bank holding companies they were able to register with the Board of Governors of the Federal Reserve System, and gain access to government funding and liquidity. Without this much needed liquidity, they simply would not exist today. By the end of 2008 there was not a single recognizable stand-alone investment bank left standing.

It's been almost 80 years since the passage of the Glass-Steagall Act, and once again the activities of investment banking and commercial banking are performed by the same firms. Although the Dodd-Frank Act was officially signed into law in 2010, most of the Act's provisions have yet to be implemented, including the Volcker Rule. The Volcker Rule's provisions are scheduled to officially take effect in July of 2012. Goldman Sachs, Morgan Stanley and several others have already closed their proprietary trading desks. Supporters of the rule claim that it will make the financial system more stable, and help to control the systemic risk that bred "Too Big to Fail". Opponents argue that the Volcker rule will greatly disrupt the ability of banks to make markets for customer trades because these activities will be difficult to differentiate from the banned proprietary trades. Also, foreign banks will not be subject to such restrictions, so U.S. banks may be less competitive in the global financial system. There is certainly truth to both arguments. The question is - what argument is more important in today's world?

It's difficult to take a solid stance on this issue. In general, I'm leery of more government regulation. There are always unintended negative consequences as a result of government intervention, and sometimes these consequences far outweigh the good that was behind the reasoning for the regulation in the first place. On the other hand, it is hard to argue with the fact that many of these banks took extreme risks with depositors' money, including loading up on sub-prime mortgage-backed securities.

Obviously there were many factors that led to the financial crisis, so it is not appropriate to zero in on the repeal of Glass-Steagall as the only cause. Though one thing is clear - the Volcker Rule could end up being the single most important provision in the entire 2,500 page Dodd-Frank bill in terms of containing systemic risk in the financial system, if it is applied properly.