



The Volcker Rule: Financial Crisis, Bailouts, and the Need for Financial Regulation

In 2007 worldwide credit markets tightened and international trade declined, resulting in economic slowdowns around the world, stock market drops, and the potential collapse of large financial institutions. Faced with the worst financial crisis since the Great Depression of the 1930s, governments and central banks around the world responded. In the United States alone, government agencies committed trillions of dollars to loans, asset purchases, guarantees, and direct spending to undertake fiscal stimulus, expansionary monetary policy, and bailouts of a variety of private financial institutions.

The bailouts were especially controversial in the United States because public money was used to protect private financial institutions and their wealthy executives while ordinary citizens received no such protection. Elected officials were inundated with mail from angry constituents denouncing the bailouts. This wave of outrage was seized upon by liberal activists, who launched the Occupy Wall Street movement to protest growing economic and social inequality and to advocate for greater economic fairness. Even on the opposite end of the political spectrum, the conservative Tea Party movement sponsored protests and supported political candidates in favor of reduced government spending and taxes to reduce the federal budget deficit and national debt.

On June 17, 2009, the Obama administration announced an “extraordinary response to a historic economic crisis.”¹

A New Foundation for Financial Regulation

President Obama’s proposal for preventing a reoccurrence of the financial crisis was contained in a document called “Financial Regulatory Reform: A New Foundation.”² The proposal included five measures:

1. Consolidate regulatory agencies and create a new regulator to evaluate systemic risk.

¹ Barack Obama, “Remarks on Regulatory Reform,” June 17, 2009, transcript and video, *Washington Post*, <http://projects.washingtonpost.com/obama-speeches/speech/23>.

² U.S. Department of the Treasury, “Financial Regulatory Reform: A New Foundation,” June 17, 2009, http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

2. Implement additional regulation of financial markets.
3. Create a new consumer protection agency.
4. Introduce tools for financial crises, including a “resolution regime” that complements the existing Federal Deposit Insurance Corporation (FDIC) authority to allow for orderly winding down of bankrupt firms, as well as a proposal that the Federal Reserve receive authorization from the Treasury for extensions of credit in “unusual or exigent circumstances.”
5. Various measures aimed at increasing international standards and cooperation.

These proposals, which the Obama administration believed were sufficient to protect against the need for future bailouts, became the basis for the financial reform law known as the Dodd-Frank Act.

Public Reaction

Earlier that year, news of lavish bonuses paid to executives of bailed-out financial firms had sparked popular indignation. In March 2009 the insurance company AIG, which had received more than \$170 billion in government bailout funds, had announced it would pay \$165 million in bonuses to managers of the business unit whose performance had sunk AIG and required it to be bailed out.³ Ten days after the *New York Times* broke the news, with AIG under a barrage of public criticism, an executive vice president of the business unit had resigned. In October 2009, however, AIG again tried to pay out large bonuses. This time the U.S. Treasury Department intervened to block the move.

These stories stirred powerful reactions in the media and among voters of both parties. This reaction led the Obama administration and Congress to believe that stronger regulation not only was politically feasible but also politically necessary. Accordingly, the administration started exploring additional regulatory options, including one that had been proposed by Paul Volcker, a respected former chairman of the Federal Reserve.

The Volcker Rule

What became known as the “Volcker rule” first had been proposed in a January 2009 report cowritten by Volcker and the Group of Thirty, an international group of senior representatives of academia and public and private sectors. The report recommended that “large, systemically important banking institutions should be restricted in undertaking proprietary activities that present particularly high risks.”⁴

Banks, unlike other financial entities, were insured by the FDIC. This insurance was a guarantee that banks would be bailed out if they were in distress. With the downside risk of bad

³ Edmund L. Andrews and Peter Baker, “A.I.G. Planning Huge Bonuses After \$170 Billion Bailout,” *New York Times*, March 14, 2009.

⁴ Group of Thirty, “Financial Reform: A Framework for Financial Stability,” January 15, 2009, http://www.group30.org/images/PDF/Financial_Reform-A_Framework_for_Financial_Stability.pdf, p. 28.

decisions being borne by the FDIC, banks might be lured into speculating for their own account; if the speculation lost enough money to endanger the institution, the public (through the FDIC) would bear the costs of the decision. This problem was known as *moral hazard*.

The solution for this moral hazard problem was to restrict banks from trading for their own account. In Volcker's words, "If you are going to be a commercial bank, with all the protections that implies, you shouldn't be doing this stuff. If you are doing this stuff, you shouldn't be a commercial bank."⁵

The Volcker rule threatened to eliminate the banks' proprietary trading revenues, or revenues from trades that banks engaged in for their own—not their clients'—benefit. The proprietary portion of trading revenues was difficult to quantify, but it was believed to be on the order of 10 percent of total trading revenues.⁶ At that figure, proprietary trading revenues in 2010 would have exceeded \$5.9 billion for the six largest American banks alone.⁷

Support

With public opinion firmly set against the bailouts and the financial industry, President Obama announced his support for the Volcker rule in January 2010. In the same speech, he took the opportunity to excoriate the financial industry:

*[W]hat we've seen so far, in recent weeks, is an army of industry lobbyists from Wall Street descending on Capitol Hill to try and block basic and common-sense rules of the road that would protect our economy and the American people. So if these folks want a fight, it's a fight I'm ready to have.*⁸

Voter support for tough action on Wall Street was overwhelming. The president's position was supported by Americans for Financial Reform (AFR), a public interest group that represented the AARP, several large unions, the NAACP, MoveOn.org, and many others. The AFR started a public campaign, including mass letter-writing to congressmen, in support of the Volcker rule. The AFR was firmly opposed to proprietary trading: "Proprietary trading and private fund investments are resulting in taxpayer-supported banks using cheap federal funds to gamble, not lend to America's struggling businesses and families."⁹

The administration's position was further strengthened when five former Secretaries of the Treasury, four of whom had served under Republican presidents,¹⁰ wrote an open letter to the *Wall Street Journal* supporting the Volcker rule.

⁵ John Cassidy, "The Volcker Rule," *The New Yorker*, July 26, 2010.

⁶ Kate Kelly, "Banks Gear Up for a Battle," *Wall Street Journal*, February 2, 2010.

⁷ Robert Lenzner, "Six Giant Banks Made \$51 Billion Last Year; The Other 980 Lost Money," *Forbes*, June 3, 2010.

⁸ Barack Obama, "Remarks on Financial Reform," January 21, 2010, transcript, *Washington Post*, <http://projects.washingtonpost.com/obama-speeches/speech/167>.

⁹ AFR, open letter to the H.R. 4173 Restoring American Financial Stability Act of 2010 Conference Committee, dated June 16, 2010.

¹⁰ President Barack Obama was a Democrat.

Opposition

Domestic banking institutions that would be subject to the Volcker rule were opposed to it for a long list of reasons: the loss of proprietary trading revenue; the competitive disadvantage at which U.S. banks would be placed relative to foreign banks; the burden of regulatory compliance necessary to certify trades as nonproprietary; the regulatory ambiguity entailed by the definition of “proprietary trade”; and the consequent uncertainty regarding enforcement.

The last two concerns were especially strong for small and community banks. Community banks provided nearly 40 percent of the entire banking industry’s loans to small businesses, which were crucial to job creation. Albert Kelly, American Bankers Association chairman-elect and an Oklahoma community banker, described the potential impact of the Volcker rule (and, by extension, the Dodd-Frank Act, to which the rule was appended) during Congress testimony regarding community banks:

*The Dodd-Frank Act will raise costs, reduce income, and limit potential growth, all of which drives capital away from banking, restricts access to credit for individuals and business, reduces financial resources that create new jobs, and retards growth in the economy.*¹¹

The banks also raised a number of policy concerns about the Volcker rule, particularly regarding interference with “market-making,” in which banks acted as counterparties for sellers of, for example, purchased government debt or a bond issued by a corporation in hopes of reselling it later. If market-making was deemed to be proprietary trading and banks were prohibited from engaging in it, then the markets for corporate and government bonds might become less liquid. This would result in the undesirable consequence of raising financing costs for private and government entities.

The banks also argued that the ability to hedge—that is, to purchase securities that diversified or attenuated the risk in a bank’s existing portfolio of loans—actually helped prevent default. If hedging activities were deemed proprietary trading and thus forbidden by the Volcker rule, banks would become more, rather than less, likely to fail.

Legislative Process

The Volcker rule was formally introduced on May 10, 2010, as an amendment to S. 3217, the Senate version of the Dodd-Frank bill. The Merkley-Levin amendment, as it was called, explicitly exempted the trading of government bonds for market-making, hedging, and underwriting. In addition, the amendment included an “indeterminate” exception for any activities that federal banking regulators deemed would promote “the safety and soundness of the banking entity.”

The amendment was intended to drive the \$5 billion in “speculative profits” out of the banking system while still permitting “good” financial activity. However, because the boundary between market-making or hedging (good) and speculative (bad) activities was not well defined, the amendment gave broad discretionary powers to the agencies charged with implementing the

¹¹ John Soffronoff, “The Dodd-Frank Act: Size Matters,” *Thomson Reuters News & Insight*, April 30, 2012.

Dodd-Frank Act. This need for discretion was widely accepted, as mentioned by Deputy Treasury Secretary Neal Wolin at a February 2, 2010, hearing of the Senate Banking Committee: “Certainly a lot of the detail would be left over to specific application in the rule-making process or the advisory process.”¹²

A number of steps remained before the Merkley-Levin amendment could become law. First, the amendment could be modified to gain support from additional lawmakers. Next, it would need to be voted as part of S. 3217. Then the amendment would need to survive reconciliation with the House version of the Dodd-Frank Act that had passed in December 2009 without a Volcker-type provision.

Once the Merkley-Levin amendment became law, government agencies would be charged with writing the regulations that would implement the letter and spirit of the law. The relevant agencies included the Federal Reserve, the Securities and Exchange Commission, the FDIC, and the Office of the Comptroller of the Currency. These agencies were run by political appointees who had technical backgrounds, and their personnel was made up of civil servants. According to administrative protocol, these agencies would first issue a notice of proposed rulemaking and solicit comments from the public, which would help shape the regulations. These comments would be regarded as influential insofar as they competently addressed specific technical issues.

Preparation Questions

1. In this case, at what stage in its life cycle is the nonmarket issue of the “Volcker rule” (regulation of proprietary trading)?
2. Map out the interests and their potential influence. Is the Volcker rule likely to pass? Why, or why not?
3. Propose a nonmarket strategy for a large bank to deal with the threat of the Volcker rule. Make sure the strategy looks not only at the current stage of the issue but at future stages as well.

¹² Rebecca Christie, “U.S. May Give Regulators Room to Apply Volcker Rule (Update1),” *Bloomberg Online*, February 24, 2010.