
Vox Populi on the 'Volcker Rule'

By Editor Test Thu, Nov 11, 2010

More than 1,400 Americans, including Paul Volcker himself (at left) commented on the proposed rule, which would ban risky 'proprietary' trading by banks. A smaller but more influential group—including insurers and the probable next chair of the House Committee on Financial Services—decried the rule.

The deadline for public comments on the so-called Volcker Rule—Section 619 of the Dodd-Frank financial regulatory bill—has just passed. The Rule would discourage banks and non-bank financial firms from “proprietary” trading and limit their involvement in risky hedge funds or private equity funds.

More than 1,400 Americans sent comments to the Treasury Department, many of them quite emotional in their support of the Rule. Hundreds of members of the activist group, Public Citizen, praised the Rule, often submitting the same boilerplate text in the fashion of grass-roots (or “Astroturf,” if you prefer) campaigns.

A much smaller but far more influential group—including Spencer Bachus, the likely chair of the House Committee on Financial Services come January—wrote to criticize the rule. Former Fed chairman Paul Volcker, the inspiration for the eponymous rule, also weighed in.

Representatives of the insurance industry, of course, sent in comments that reflected what they’ve asserted publicly: that variable annuity and variable life insurance separate accounts should “not fall under the purview of the Volcker Rule.” If separate accounts were classified as hedge funds or private equity funds under the Rule, they said, insurers might be hindered or prevented from using them. That would be a game-changer, and not a good one.

'Mass exodus' feared

Bachus, a Republican congressman from Alabama, argued that the Volcker Rule would weaken the competitiveness of the U.S. financial sector. It “will spark a mass exodus of clients from U.S. banks to banks based abroad” that are not barred from proprietary trading, he wrote.

More specifically, the Rule would deprive U.S. private equity funds of an important source of financing by preventing banks and investment banks from investing in them, Bachus wrote. Flows to U.S. private equity funds dropped by 90% from fourth quarter 2007 to fourth quarter 2009, to \$10 billion, he claimed. Bottom line, he said: proprietary trading didn’t cause the financial crisis.

Others charged the opposite. Simon Johnson, an MIT professor and blogger at baselinescenario.com, wrote, “Mismanagement of risks that involved effectively betting the banks’ own capital was central to the financial crisis of 2008... the separation between banks and the funds they sponsor, in any fashion, needs to be complete.”

Johnson worries that the failure of a risky hedge fund or private equity fund can bring down the bank that

sponsored it and, if the bank is big enough, jeopardize the whole financial system. Not so, say BNY Mellon, Northern Trust, and State Street Global Advisors.

Lawyers representing those institutions argued that certain kinds of “sponsorship” by banks of speculative funds are benign. Banning all sponsorship through the Volcker Rule, they say, would kill healthy and even essential activities along with excessively risky activities.

“Preventing banks from offering normal banking services in connection with directed trustee services to funds would be highly disruptive, particularly for pension plan sponsors and beneficiaries, and could undermine the competitiveness of U.S. custody banks,” wrote attorneys from those three giant banks.

The voice of the people

In contrast to the bank’s legalese, the individual Americans who wrote to the Treasury’s Financial Stability Oversight Committee were bluntly, emotionally, succinctly and almost categorically in favor of establishing the Volcker Rule and even perhaps reinstating the Glass-Steagel Act of 1999, which de-regulated banking activities. Here are a few representative samples of the hundreds of spontaneous comments:

- “Stop the fraud. Regulate financial transactions by banks. No more bailouts with citizens’ money”—Abigail Winston, sole proprietor.
- “Banks should be freed from the incentives of the derivatives market so they can fully appreciate the incentives of investing in real markets. People here in Texas aren’t only up in arms about it, they’re practicing their aims. Be careful how far y’all let things slide before someone decides to add that critical spark to the well fueled fire-pit”—Sam Houston State University
- “We must control the Banksters and Wall Street, if we are to have a government of, for & by the People”—Lewis Patrie, Physicians for Social Responsibility
- “Stop gambling and play by the rules the rest of us follow”—Don Cramer, retiree.
- “I think you must look VERY carefully at any deregulation of Wall Street. They have committed a HUGE amount of destruction and are busily going Who? Me? now. You must think of the good of the country and apply standards as rigorous as you would apply to the safety of airplanes, hospitals etc. Not doing so would be saying that, well, blah, let’s just fail here”—Bill Jaynes, Swan River Software

Volcker’s own view

Paul Volcker himself wrote to Treasury Secretary Tim Geithner to comment on the Volcker Rule. He spoke, not surprisingly, in favor of the rule. Though not in so many words, he seemed to describe the spirit of the rule as this:

That banks should no more invest in hedge funds and private equity funds on their own account than a lawyer should sue corporations for negligence and compensatory damages without first having an injured client. “Hedge and private equity funds should be aligned with and support established customer-focused asset management business,” he wrote.

Volcker took note that proprietary traders at the banks might, like attorneys who advertise for injured clients after they decide to file a class-action lawsuit, seek cover in legitimate market-making activities for customers:

"The press has carried reports that proprietary traders of banking organizations are being reassigned where their professional skills may be utilized for market-making within existing customer trading and investment management operations," he wrote.

"I am conscious that some of those reports suggest implicit (or even explicit!) expectations that proprietary trading may continue in that guise. The ability of supervisors should be clear to undertake close scrutiny of trading books if there is reason to suspect significant proprietary activity may exist and be tolerated by management."

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