Let’s Not Pursue the Volcker Rule
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I will not start by thanking myself for putting me on this panel. But I would like to thank Dave Wessel, Governor Tarullo and President Evans for participating. The normal temptation for an academic who gets an audience with such a distinguished group of policymakers is to promote one’s latest and greatest new idea. But having tried that on numerous occasions with pretty limited success I am going to take a differ tact. Instead, I am going to say some things that I think many and perhaps most policymakers already understand and agree with, but perhaps feel uncomfortable pushing. So I am going speak primarily to the members of the audience who are not policymakers and especially the press to try to change their thinking on the so-called Volcker rule.

In particular, I will make a frontal assault on the wisdom of having the Volcker rule as the headline feature of regulatory reform efforts. For these purposes I will define the Volcker rule as restricting banks from making speculative investments that do not benefit their customers. I want to attack it on theoretical grounds, question its empirical relevance, and explain why I believe it is even bad politics.

Theoretical considerations

Starting with the theory, that there are fundamentally two theories of what banks do and why they are special. One emphasizes the role that banks play in monitoring customers who want to borrow money. The other stresses the importance of offering liquidity on demand. When thinking about regulating banks it is critical to decide which of the two motives matters. I want to stress the liquidity provision theory and think about its implications.

Let’s take perhaps the simplest version of that theory. It is based on the proposition that there is an underlying demand for payment services that someone must offer. It can be summarized as saying we have checking accounts because using them is much more efficient than carrying around large amounts of cash. So there is an intrinsic demand for debit type payment options.

Now let’s think about how this preference will be met. To successfully offer demand deposits, a bank needs ready access to funds and to develop the infrastructure to predict when cash will be withdrawn. But notice that solving this problem is identical figuring out when a customer might draw on a line of credit. For the bank, it makes little difference whether money is flying out the

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1 These remarks are my own personal views and should not be associated with the organizations with which I am affiliated.
2 A lot of recent work by my colleagues, Douglas Diamond and Raghu Rajan, try to put the two together.
door because a customer writes a check or draws on a commitment. Either way, the bank has to have the money ready.

But this means the same buffer stock of funds that a bank would hold to service checking withdrawals allows it to also offer loan commitments. So it will necessarily be cheaper for banks to offer each product than any other organization that was only offering one of the two products.

This theory explains lots of banking regularities, both historical and current. Most importantly, it explains why since medieval times banks have always offered overdraft protection (the historical version of a loan commitment). But it also explains why, looking across banks, those which are more deposit-intensive tend to offer more commitments.

Finally, it explains why in a crisis the banking system can be a source of stability. During many times of stress a flight to safety people to move their money into the banking system. This inflow delivers cash to the banks exactly when some of their customers may need to borrow, so the banks can continue lending. This pattern was carefully documented in the Asia financial crisis.

Why does this perspective on the banks matter for regulation and the Volcker rule? First, it is fashionable to talk about narrow banks that only offer deposits and invest in safe securities. This seems like the simplest and most direct way to stop the banks from needing bailouts and contributing to economic instability. The theory explains why we do not see these types of banks occurring naturally. It also tells us that splitting the lending operations and deposit-taking operations would entail major efficiency costs. For the same reasons why insurance companies want to offer insurance on different types of risks, banks find it efficient to take deposits and offer commitments.

Second, the lending side of the bank may naturally want to hedge certain types of risks that emerge once a loan commitment is drawn upon. For instance, this might include eliminating foreign currency risk, or interest rate risk. There is no good reason to ask the banks to shoulder these risks. How theoretically is the Volcker rule to be applied to identify these worthy hedging activities and separate them from gambling?

Empirical Relevance

Let me know move away from my theoretical concerns and turn to some empirical problems.

First, measuring the importance of proprietary trading is challenging. There are no published financial statements that allow us to separate this activity from total trading revenue. Direct measurement of this part of the business is therefore impossible. But, based on what the banks say, they believe proprietary trading to be small. For instance, Goldman Sachs’ CFO estimated that about 10% of their trading revenue was from “walled-off proprietary business that has nothing to do with clients.” Bank analysts have used that number to extrapolate to other large
institutions (which generally have less trading revenue than Goldman). For example, a report by Wells Fargo estimates that Morgan Stanley would have roughly 3 to 4 percent of revenue from prop-trading and Bank of America and JP Morgan would have less than 2 percent.

Of course, if one wants to cast a wide net to say clients do not benefit from anything involving a derivative security, then the magnitude of the alleged gambling is much larger. But in this case, then the concern over killing all hedging becomes paramount.

Second, let’s look back at the central problems for the financial system and the main costs to the taxpayer from this crisis. They have had virtually nothing to do with proprietary trading by banks. Under the Volcker rule, the problems at Bear Stearns, Lehman Brothers, and AIG would have been identical to what we saw. These institutions would have been exempt from restrictions on their activities. If we learned anything from the crisis it is that firms that are deeply inter-connected to the financial system can wreak havoc, regardless of their size, and that the inability to gracefully wind down such firms is a major shortcoming of the current system.

Third, if we were to restrict activities, the crisis suggests that the obvious place to focus is on Prime-Brokers. I hope none of the people in this room are still trying to recover their money from Lehman’s UK brokerage, but it would not surprise me if someone were in that position.

In the Lehman bankruptcy we learned the extent to which a broker was using securities (and extra collateral) provided by clients to support lending. As Lehman got into trouble some clients pulled their money and this forced Lehman to contract (or find new funding). Once the failure occurred some clients were not able to recover their securities.

There is a vigorous debate currently underway as to whether client assets should segregated from the broker’s funds. This would certainly have made the failure less traumatic. But it also would forces assets that could circulate in the market providing other services, for example for shorting purposes or to back further secured loans, to sit idle.

Because of this tradeoff deciding how fare to go regarding segregation is challenging. But I think there is no doubt that if we want to talk about limits on bank activities this is THE area to be discussing.

Political considerations

Finally, let me close by explaining why I think all the attention on the Volcker rule is also bad politics.

I see a close analogy to the TARP debate. Remember that initially it was sold as request for Congress to allow the Treasury to buy toxic assets. Many of us kept asking for an explanation as to how this would work, while arguing instead that a capital injection for the banks was needed. When the Treasury changed its mind and switched course, the public and the politicians felt misled and lost confidence in the process. (As Alan Blinder likes to point out, the public’s band
width on these matters is pretty limited: he notes that because the TARP request was for 700 billion and the stimulus was 787, so that both figures started with a 7, the average person can’t tell them apart! I think he is right.)

Once again we see that the administration’s headline recommendation does not pass the sniff test -- no one can explain how the Volcker rule would have helped in the last crisis, and the reason, as I just explained, is that it wouldn’t. On the other hand, I think all experts would tell you that getting resolution authority would make a huge difference. The next time a Lehman event looms we want to be able to have many more tools to use to fail the firm or to sell it off more smoothly. The fact that we do not have any better options than we did in September 2008 is a major disappointment.

I am sure that people from the administration would claim I am being unfair and that the Volcker rule is just one part of its package of reforms and that they want resolution authority too. Technically speaking that is true. The administration has put out several reform proposals, including some that are pretty comprehensive and that I would be prepared to support.

But the details on this legislation are critical and as the President is fond of pointing out there are many entrenched interests who oppose reform. The global linkages in the financial system mean that many of the reforms require international cooperation that will take sustained efforts. I think harmonizing bankruptcy rules will be a task measured in years. For this reason, it is essential for focus on getting started on this immediately before the next crisis.

The Volcker rule is particularly bad on this front because it is so easy to remember: diagnosis, the banks were gambling, solution, we need to stop it. Who can be against this idea? The public is sure to remember this idea.

Keep in mind also, the way international meetings work. Much of the task of financial reform has fallen to the Group of Twenty nations. There will be meetings later in the year where heads of state gather to discuss financial reform and various other issues. Imagine the table where all 20 leaders are seated and they each take turns to start the meeting by giving 6 minutes of opening remarks – this means it takes 2 hours just to finish introductions! If the Americans keep pushing this kind of reform, then it is guaranteed that this will be on agenda. What elected leader will be able to pass up the chance to beat up the banks over their reckless gambling? Most politicians would rather go to the dentist than talk or think about financial regulation reform. So once they are given the chance to rail against reckless bankers that will be the end of the discussion – it will simply suck the oxygen out of the room. Serious reform discussions will be totally crowded out.

So while admire Paul Volcker and I thank him for many contributions to central banking, on this issue I hope he does not succeed. Instead, I hope the next time the President wants to talk about financial regulatory reform, and he needs a sound bite, he switches to talking about putting financial institutions through bankruptcy and how it is not fair that the man on the street can be
taken to bankruptcy court, but large banks can’t. I think that is a message that would resonate but would be much better priority.

Thanks for your attention.