SHADOW FINANCIAL REGULATORY COMMITTEE

Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

Statement No. 350

Richard Herring
(215) 898-5613

Ken Scott
(650) 723-3070

Chester Spatt
(412) 268-8834

Philip E. Strahan
(617) 552-6430

Statement of the Shadow Financial Regulatory Committee on

Regulating to Beat the Clock: The Final Implementation of the Volcker Rule

February 10, 2014

Although the Shadow Financial Regulatory Committee has previously (Statement No. 334, December 10, 2012) questioned the underlying premise for the 2010 Dodd Frank Act's Volcker Rule, the rule making process is now completed. The original proposal was extraordinarily complex, entailing 530 pages and including a request for comments on 383 specific questions. This drew an avalanche of comments, emphasizing the difficulty of distinguishing underwriting, market-making and hedging from proprietary trading as well as of defining the scope across firms and the international reach of the Rule. This Rule was a joint promulgation of four independent regulatory agencies that experienced enormous difficulty in reaching agreement.

Under recent pressure from Secretary of Treasury Jacob Lew to produce a final rule by the end of 2013, the agencies produced an example of the dangers of a rush to regulate without fully understanding the potential unintended consequences involved. Because it differed substantially from the original proposal, the rule adopted should, under normal Administrative Procedure Act requirements, have undergone another notice and comment review. It should also have required a second and appropriate cost-benefit analysis.

One particular unintended consequence led to an immediate regulatory response to industry complaints about the rule. The Volcker Rule as adopted on December 10, 2013 required banking entities to divest Collateralized Debt Obligations (CDOs) backed by trust preferred securities. Immediate deluge of immediate sales could have led to fire sale losses. Although the regulators made allowance for this possibility by providing a lengthy compliance period, they failed to take account of the immediate accounting consequences of requiring divestment. Well-established accounting rules would require that those securities be classified as available for sale and thus fair-valued, rather than continuing to be classified as held to maturity and valued at amortized cost. This would have required the recognition of any losses in year-end financial statements.

The regulatory authorities hurriedly responded to this unintended consequence of the Rule on December 27, 2013, by postponing implementation until January 15, 2014. Then on January 14, 2014, they reversed their position by adopting an "interim final" rule permitting their retention (http://www.federalreserve.gov/newsevents/press/bcreg/20140114b.htm).

Additional unintended consequences are likely given the Rule's lack of clarity. To satisfy Secretary Lew's charge, the regulatory authorities finessed many of the subjective and contentious issues surrounding the identification of proprietary trading by transferring responsibility to the firm and its CEO, who must attest that the firm has in place policies and procedures "to achieve" compliance with the Rule. This transfers responsibility for resolving the uncertainties inherent in defining proprietary trading from the agencies to the firm and its CEO. Unfortunately, the Rule lacks sufficient clarity for the CEO to make a legally safe attestation or for regulators to make an objective evaluation of compliance.

For another example, enforcement responsibilities are not clearly delegated across the regulatory agencies, and the Rule may encourage prohibited trading to move to jurisdictions not subject to the Rule's restrictions. The net effect on US financial stability was not analyzed by the agencies nor commented on by the public. All of this makes it difficult to forecast the effectiveness of the Rule.