CENTER FOR CAPITAL MARKETS COMPETITIVENESS

The Volcker Rule

The Volcker Rule bans proprietary trading, and certain investments by banks to limit and regulate the amount of risk they can take on. Proprietary trading occurs when a financial firm uses its own funds to trade financial instruments, such as stocks and currencies for profit and to y to establish an inventory that enables faster transactions for clients. However, "proprietary trading" is an ambiguous term, that even Chairman Paul Volcker, the rule's namesake, could not define. With the passage of Dodd-Frank banks have already been unwinding their prop trading operations, but the proposed implementing rules create a complicated and burdensome compliance system that calls into question any trading undertaken by a bank. The ambiguity of, and implementation issues surrounding the Volcker Rule are likely to have a chilling effect on many legitimate services that banks provide to their clients.

The Volcker Rule will…

- **reduce the ability of main street businesses to raise capital**
- **result in higher costs for borrowers**
- **force higher bank fees for consumers and businesses**
- **change long-standing business models of banks to act as market makers to the detriment of clients and investors**
- **restrict trading in proper and allowable business**
- **bar mid-size and small cap companies from some debt markets**
- **place American firms at a competitive disadvantage**
- **force some non-financial companies to develop and establish compliance programs**

This is not a "Wall Street" issue.

If implemented in its current form, the Volcker Rule will have wide-ranging adverse impacts upon regional and medium-sized banks with severe repercussions on the ability of main street businesses to raise capital in order to expand and create jobs.

The Unintended Consequences of the Volcker Rule

The Volcker Rule may impair market liquidity reducing the ability of companies of all sizes to raise capital.

How will the Volcker Rule impair liquidity? The Volcker Rule will impair the ability of banks to be "market makers" that act as significant buyers and sellers of securities to ensure that borrowers can find investors and investors can find investments. To perform this "market making" function banks need to hold inventory, but the Volcker Rule significantly constrains their ability by dictating how banks should manage their inventory. This will reduce the depth and liquidity of our capital markets.

For example, main street businesses rely upon the market making activities of banks in order secure affordable funding in the bond market. Banks provide this service as an incident to underwriting bond issuances. This funding is critical for a wide-range of business activities, from funding payroll to business expansion and R&D. If banks can no longer hold inventory it will be harder for main street businesses to raise capital.

The Volcker Rule will result in higher costs for borrowers.

With the reduced market liquidity imposed by the Volcker Rule, borrowers would need to pay higher rates for debt that they issue in order to compensate investors for the elevated risk that they may not be able to find another buyer if they need to sell.

The Volcker Rule will increase the cost of capital for all companies. These increased costs coupled with administrative burdens will prohibit some mid-size and small companies from entering debt markets. In addition, because Basel III may restrict the ability of those same firms to access bank lending, access to the capital markets will be more important than ever.

The Volker Rule will restrict trading in proper and allowable business.

The proposed Rule is inherently complicated and forces regulators to define the intent of a trade. The complexity and vagueness of the Volcker Rule will force banks to adopt the most conservative interpretation of the rule in order avoid costly and disruptive investigations into whether they are complying with the rule. The net result will likely be the elimination of perfectly acceptable "market making" activities.

The Volcker Rule will place U.S. businesses at a competitive disadvantage.

The United States' major trading partners have rejected the Obama Administration's request to follow the Volcker Rule putting American companies at a competitive disadvantage. By eliminating a core revenue stream from U.S. banks, the Volcker Rule would effectively reduce the ability for U.S. banks to compete and expand into overseas markets. Additionally, in order to avoid the Volcker Rule, foreign financial firms may curtail U.S. operations further depriving American businesses of capital.

The Volcker Rule will force some non-financial companies to develop and build compliance programs.

Non-financial companies that own banks or financing arms will have to build compliance programs even though they do not engage in proprietary trading. Also, companies that use derivatives as an everyday risk mitigation tool will face increased costs and additional compliance burdens.

The Volcker Rule will likely result in higher bank fees for consumers and businesses.

As discussed above, the cumulative effect of regulatory changes such as the Volcker Rule and Basel III will reduce or eliminate core bank revenues. At the same time, the Volcker Rule will materially increase the costs of regulatory compliance. To continue offering the services and infrastructure consumers expect, American banks in turn would need to increase banking fees for consumers and businesses in order to offset this combination of lost revenue and increasing expenses.