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Analysis of the Dodd-Frank Volker Act

Introduction

A reliable and enduring financial policy is a desired and meaningful matter within stable countries. A subset of stabilizing financial policy centers on protecting investors' savings and preserving the monetary system's integrity in total. Typically, the responsibility for financial oversight exists outside of public scrutiny. However, when critical parts of the financial system fail or are severely stressed, such as during the Great Depression and the Financial Crisis of 2008, an overhaul of banking systems and bank supervision may become necessary. The stated objective of the Dodd-Frank legislation and specifically the Volcker Act is: "to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."[1]

The Volcker Rule, named after the 12th chairman of the Federal Reserve, Paul Volcker, pertains to Section 619 of the Dodd-Frank Act, a regulation whose intent was to restrict U.S. banks from using their depositors' capital to participate in speculative trading activities[2]. The rule explicitly addresses activities involving a banks' participation in risky speculation non-beneficial to customers. The edict also prevents banks from owning or investing in hedge funds or other

[1] Ian A. Engoron, Note, A Novel Approach to Defining "Whistleblower"https://ir.lawnet.fordham.edu/jcfl/vol23/iss1/5/.
[2] History.com Editors, "Dodd-Frank Act," January 26, 2018, https://www.history.com/topics/21st-century/dodd-frank-act.

private equity funds. However, to truly understand the Volcker Rule and its part in the Dodd-Frank Act, one must first consider the Glass-Steagall Act (1933) and the Bank Holding Company Act (1956), and the Financial Services Modernization Act of 1999.

The Glass-Steagall Act

The Great Depression of the 1930s ravaged the U.S. economy. Many blamed the economic meltdown on the financial industry's defective practices and short-sighted banking regulations—the Glass-Steagall Act of 1933, which came about during the Great Depression and preceded the Dodd-Frank Act. Glass-Steagall folds into a comprehensive set of regulations, known as the Banking Act of 1933, which prevents investment banks from owning a controlling stake in retail banks. Glass-Steagall boosted consumer trust in the U.S. banking system during one of the most significant financial downturns in the country's history by forcing banks to use depositors' funds only in safe investments. Furthermore, its FDIC insurance program prevented further bank runs. Depositors gained assurance from the federal government of protection from the possibility of a failing bank[3].

The Bank Holding Company Act

Throughout the United States, for most of the 1800s and 1900s, a long-held concern has existed that large banks would concentrate financial power. Resistance to banks operating multiple off-site banks in multiple states existed in the United States. A reason for this objection was a generally held belief that bank branching would give large banks from metropolitan areas a

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[3] Julia Maues, "Banking Act of 1933 (Glass-Steagall)," Federal Reserve History (Federal Reserve Bank of St. Louis, November 22, 2013), https://www.federalreservehistory.org/essays/glass-steagall-act.

competitive advantage over state banks in smaller towns and against national banks, which were initially allowed to operate only a sole bank. Eventually, banks in the mid-1950s structured themselves into bank holding companies to avoid the numerous restrictions placed on bank branching. This strategy allowed banks to operate branches in multiple states where they operated as independent banks and consequently remained in compliance with the law. The Bank Holding Company Act was enacted into law in 1956, giving the Federal Reserve further oversight of the banking industry. This act redefined a bank holding company as any company which held a stake of 25 percent or more in two or more banks. Stake holding included outright ownership as well as control of or the ability to vote on shares. The law defined any institution that takes deposits and makes loans as a bank holding company. The Bank Holding Company Act also mandated bank holding companies to divest ownership of any non-banking organizations. Once bank holding companies were defined, previous regulations could be applied to curb undesired behavior[4].

The Financial Services Modernization Act

Based on many lawmakers' and economists' opinions, a healthy skepticism developed regarding the prohibitions advocated in Glass-Steagall. Throughout most of the mid-80s and early 90s, a massive banking industry consolidation began; "the number of commercial banks in the U.S. fell from 14,000 in 1984 to 9,000 in 1999."[5] After decades of lobbying and proposed legislation, a piece of legislation emerged to overcome the banking industry's perceived over-regulation. In November of 1999, the Financial Services Modernization Act's enactment

[4] Joe Mahon, "Bank Holding Company Act of 1956," Federal Reserve History (Federal Reserve, November 22, 2013), https://www.federalreservehistory.org/essays/bank-holding-company-act-of-1956.
[5] Joe Mahon, "Financial Services Modernization Act of 1999, Commonly Called Gramm-Leach-Bliley," Federal Reserve History (Federal Reserve, November 22, 2013), https://www.federalreservehistory.org/essays/gramm-leach-bliley-act.

effectively repealed banking statutes from the Glass-Steagall Act of 1933 and the Bank Holding Company Act of 1956. In 1999, with financial consolidation fully underway, Congress responded by passing the Financial Services Modernization Act. The goal of this legislation was to make U.S. financial firms globally competitive. The repeal of Glass-Steagall allowed for the amalgamation of investment and retail banks through financial holding companies, removing obstacles to banks' participation in speculative ventures using depositors' accounts.

<u>Dodd-Frank and the Volcker Rule</u>

The housing boom of the early to mid-2000s saw Lehman Brothers and other Wall Street firms become heavily involved in collateral debt obligations. As housing prices started to fall in mid-2006 rapidly, many subprime borrowers began to default on their payments, exhibiting these debts' risky nature[6]. In December 2007, a financial crisis occurred, leaving millions of Americans unemployed and sparked worldwide economic decline. “On September 15, 2008, the venerable Wall Street brokerage firm Lehman sought Chapter 11 bankruptcy protection”[7], becoming the most prominent victim of a subprime mortgage crisis that would devastate financial markets and contribute to this massive economic downturn. This crisis lasted well into 2009. Investors were over-extending their capital and depleting their financial savings. The federal government moved quickly, proposing legislation for financial reform. Congress enacted Dodd-Frank and the Volcker Rule in 2010. Some critical elements of the Volcker Act are the prohibition of banks from engaging in proprietary trading, owning or investing in hedge funds or private equity funds, and limiting liability holdings for the largest banks[8].

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[6] Keith Goodwin, “Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,” Federal Reserve History (Federal Reserve , July 21, 2010), https://www.federalreservehistory.org/essays/dodd-frank-act.

[7] History.com Editors. “Dodd-Frank Act,” January 26, 2018. https://www.history.com/topics/21st-century/dodd-frank-act.

[8] Dan Burrows et al., “JPMorgan: The Bank That Kicked the Hornets' Nest,” InvestorPlace (InvestorPlace, May 23, 2012), https://investorplace.com/2012/05/jpmorgan-the-bank-that-kicked-the-regulatory-hornets-nest/.

Regulation of Banking

The banking industry is one of the most heavily regulated industries in the United States. Over-regulation of banks is an important matter, not just to banks but to the entire U.S. economy. The United States needs to have a healthy banking system for the economy to thrive. However, banking is laden with hazards; banks, by necessity, are highly leveraged to play their economic growth role. Banks contribute significantly to economic growth. They provide capital, which is one of three variables that dictate the size and direction of an economy -- the other two being labor and productivity[9].

Banks perform this service by aggregating people's savings land then lending that money out to individuals and businesses. Overregulation stifles competition, significantly increases compliance costs, and diverts capital that could otherwise serve customers. "Despite a shared objective of maintaining the safety and soundness of the financial system, today's banking environment is typified by a relationship between institutions and governing agencies that is less than collaborative."[10]

Conclusion and Analysis

The Volcker Rule was created to mitigate risk and protect consumers. Two main arguments surround the rule: a bank should be serving and protecting customers, and the involvement in risky trade does not serve customers when a bank uses deposits for trading activity to maximize their own value. The impact of the Volcker financial reform was quite

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[9] John Maxfield, "The Collateral Damage of Overregulation," The Motley Fool (The Motley Fool, March 8, 2016), https://www.fool.com/investing/general/2016/03/08/the-collateral-damage-of-overregulation.aspx.

[10] John Maxfield, "The Collateral Damage of Overregulation," The Motley Fool (The Motley Fool, March 8, 2016), https://www.fool.com/investing/general/2016/03/08/the-collateral-damage-of-overregulation.aspx.

different from its intent. The Volcker Rule created a burden on consumers by making the market less efficient and increasing consumer fees. These burdens outweigh the original purpose of the rule[11].

The removal of the Glass-Steagall Act was blamed for impacting the 2007-2008 financial crisis negatively. While this act's repeal allowed banks to become too large to fail, the crisis cannot solely be blamed on this. Borrowers and lenders were reckless with money. The debt owed was worthless as it could not have been paid by borrowers. The Dodd-Frank Act was an overreaction to the crisis and was based on the false idea that under-regulation of banks caused the financial crisis. If the existing rules were adhered to, the plight of the financial system might have been lessened.

The Dodd-Frank Act and Volcker Rule were supported by the previous administration and was an attempt to prevent a futuristic financial crisis. However, the Volcker Rule was distorted, and implantation was not thoroughly thought out. The Volcker Rule overregulates banks and denies their ability to serve customers and further economic gain.

[11] Shay Raoofi , "The Volcker Rule: A Regulatory Vice Under the Guise of Consumer Protection," *26 Loy. Consumer L. Rev*, 2014, https://doi.org/http://lawecommons.luc.edu/lclr/vol26/iss2/5.

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