Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Shaw Petrou

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Since we sent out our first assessment of the Volcker Rule rewrite and I discussed it with NPR, I've heard a lot about whether our analysis under-estimated the risks to which the revisions would put the financial system. Much of the push-back to the proposal comes principally because it changes an Obama-era rule and thus is on its face suspect. This isn't entirely unreasonable given the President's pledge to do Dodd-Frank a "big number," but these politics miss the point. With this proposal, the agencies took a very tentative, but first-time-ever step to putting the onus for compliance not on trading banks, but on themselves. Those skeptical that this will protect the innocent have good reason to worry – regulators before the crisis were captive both to the industry and "efficient-market" expectations. But, is it really wrong to expect supervisors to watch carefully and sanction forcefully?

After 2008, the regulatory balance shifted to rules so picayune that bank risk-management czars and czarinas often created compliance cultures which bear as little resemblance to strategic-risk standards as paint-by-numbers bears to art. Following suit, bank examiners picked apart the details of bank operations, all too often missing real risks not directly captured in a particular regulatory details.

Think about all the violations related to mortgage-bank servicing that put borrowers at still greater risk without any regulators being the wiser for it. Most of the AML problems at U.S. banks were initially self-reported, not caught. The "London whale?" Wells Fargo? Just where were the examiners? WaMu or Countrywide before 2008? I well remember warning then-FDIC Chair Bair in July of 2007 that these big lenders were bound to blow up, only to be told that this was news to the FDIC. None of the supervisors directly involved were worried so neither was she.

The Volcker rewrite moves the balance back to regulators, at least a little. As Chairman Powell said when the Board finalized the proposal, it requires supervisors to know when trading banks violate position limits. Fed supervisory staff assured him that they could and would, but skepticism is sensible – the regulators' record is not replete with early remediation or effective enforcement ahead of an all-too-well-known fact.

But, does a long history of supervisory screw-ups mean that banks must be bound by rules so detailed that purpose is obscured by hundreds of pages of terms and conditions only lawyers love? Is it really impossible to expect banks to adhere to law and rule that regulation must try to bind them hand and foot?

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The law promulgating the Volcker Rule is actually a relatively simple, short injunction to prohibit risky proprietary trading. Why does this required hundreds of pages of excruciatingly-detailed rules? As Mr. Volcker himself has urged, the basic point of the law – to ban banks from betting with other people's money for personal or institutional profit – is best preserved by clear regulatory standards backed by effective enforcement.

The idea here once was called "principles-based" regulation. In this model, law set goals, regulation defined how goals were to be met in overall terms, and banks then met market demand as best they could within the parameters of these laws and rules as they, their counsel, examiners, and the plaintiff's bar understood them. "Principles-based" regulation got a very bad rap after 2008 and rightly so. Many industry trade associations and even some regulators – see the U.K. – conflated principles-based rules with "light-touch" ones. These rules weren't light-touch – they were *de facto* no-touch standards.

The way to make principles-based rules work well is to pair them with heavy-touch supervision. Rules do not have to be hundreds of pages long if regulators know what they want, expect regulated institutions to adhere to these mandates, and ensure that supervisors are ever-ready to sanction companies that stray long before violating the rules goes from being an occasional lapse to an embedded business model. Add in real market transparency – not blizzards of incoherent, conflicting filings – and a really effective recovery-and-resolution regime and we would really have a sound banking system able to meet reasonable market needs because undue risk and improper action would be sanctioned not only by supervisors, but also investors.

Pre-crisis principles-based standards were not only feather-light, but floated around in markets assured that any big bank that bet too much would be bailed out. Fix that destructive incentive alignment, and you fix far more than the still over-complex Volcker Rule ever can.

As I've noted, what stuns me as I've provided expert advice in failed-bank cases is how long troubled banks were allowed to bumble from risk to still more risk as supervisors first stood by and then did little more than wring their hands. In 1992, the hard lessons of two banking crises led Congress to mandate "prompt corrective action." The agencies issued rules about this, but did nothing thereafter to enforce them until, literally, a day or two before a long-troubled bank was finally put into receivership or forced acquisition. In 2010, Congress rightly decided that the agencies hadn't acted either promptly or correctively. They thus added Section 166 to Dodd-Frank, mandating "early remediation." Although the agencies have issued thousands of detailed rules, dozens of explanations and FAQs, and exhaustive examination manuals on all things large and small, the early-remediation rules have not budged since the Fed issued an implementing proposal in 2012.

Regulators are clearly far more comfortable regulating everyone but themselves. Removing the incoherent "short-term intent" test that never could be complied with clearly enough to ensure adherence, the Volcker proposal now uses well-known accounting terms designed to identify trading assets and position bumpers designed to keep proprietary trading in permissible zones. This is a great start, but a 373-page proposal atop hundreds of pages of unchanged rules on which the agencies pose 342 questions will only make matters worse. Lawyers love this stuff, compliance staff and consultants have jobs for life, but what of market liquidity and effective hedging?

Regulators needs to do far more to hold themselves accountable. Although a nice start on rules with clearly enforceable criteria, the Volcker proposal is still in its entirety a bewildering array of complex injunctions, caveats, and confusions. The agencies have promised to do a bit more to the Volcker framework, but the text of all of the questions in the proposal suggests that the new, "improved" version will be still more complex. As a result, supervisors are still likely to do little more than micro-manage complex banks, miss threatening trees and still more frightening forests. Endless weed-pulling continues until the next crisis and Congress tries again.