

Federal Reserve Releases Staff Paper on the Impact of the Volcker Rule

January 5, 2017 | Client Update | 2-minute read

On December 22, 2016, the Federal Reserve released a [staff paper](#) on the implementation of the Volcker Rule and its impact on bond market liquidity, particularly in times of market stress. The paper studies the liquidity of downgraded corporate bonds before and after the implementation of the Volcker Rule and finds that the rule may have “serious consequences for corporate bond market functioning in stress times.” The paper ultimately concludes that “the Volcker Rule has a deleterious effect on corporate bond liquidity and dealers subject to the Rule become less willing to provide liquidity during stress times.”

One challenge in implementing the Volcker Rule is complying with the market-making exemption to the prohibition on proprietary trading. The paper suggests that ambiguity as to what is legal market-making and what is prohibited proprietary trading may push dealers covered by the Volcker Rule toward more conservative trading strategies, leading to less liquid markets. The authors of the paper determine that “[w]hile dealers not affected by the Volcker Rule have stepped in to provide liquidity, we find that the net effect is a less liquid corporate bond market.” By identifying and sorting dealers by their exposure to Basel III, the authors rule out that the effects on dealer behavior are due to the implementation of Basel III in conjunction with CCAR requirements.

Although the Volcker Rule’s impact on liquidity is not a new concern, at a time when the future of the Volcker Rule is the subject of much speculation, the paper may buttress a repeal of, or amendment to, the Volcker Rule. How such a repeal or amendment would be effected remains uncertain.

Law clerk Madison J. Roberts contributed to this post.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Gabriel D. Rosenberg

+1 212 450 4537
gabriel.rosenberg@davispolk.com

Margaret E. Tahyar

+1 212 450 4379
margaret.tahyar@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.