White Paper

Thoughts on the Volcker Rule

Will it make the world a safer place?

Adsatis

Written by David Frost – Senior Consultant, Adsatis Ltd

EXECUTIVE SUMMARY

The Volcker Rule has entered its two year implementation phase, although regulators are still drafting the final detail. We think that now is a good time to take a look at the motivation behind the Rule, how the banks will remodel their businesses around it and what the future landscape of risk-taking may look like. We consider whether the Volcker Rule has actually missed its intended target and what role proprietary groups and proprietary risk actually played in the financial crisis. We conclude that the Volcker Rule will still leave the banking system vulnerable.

We look at the exemptions to the Rule and consider how they are going to be policed and indeed whether they may cause their own problems. We also consider how market-makers will be affected by the Rule and how the Rule will handle the issue of inventory. We conclude that the post-Volcker environment will not be any safer and question whether an opportunity to put in place something more effective has been missed. We believe that the Rule may incentivise banks to find new arenas in which to take risk that are less regulated and that, consequently, regulators may again be blind-sided in any future crisis.

The Volcker Rule will force risk from the banks into the hedge funds and similar non-bank vehicles but we disagree that this will make the financial world inherently safer. We understand the motivation behind the Rule but think that the detail will promote a culture of avoidance rather than encouraging conformance with its intent. We argue that an industry-wide move towards more holistic risk-management practices, a more pragmatic understanding between the senior bankers and the regulators on the nature of risk, plus effective powers for the latter to curb risk where systemic threats are identified, would be much more effective.

INTRODUCTION

Dodd Frank Act Title VI Section 619 is popularly named after the former Federal Reserve chairman, Paul A. Volcker, who proposed that Congress should restrict banks' investments in order to reduce future systemic risks. The Volcker Rule seeks to prohibit banks whose deposits are federally insured in the US from trading for their own benefit, commonly known as "proprietary trading".

This paper explores the possible ramifications of the Rule as the regulators grapple with its implementation. We have already seen that crafting the detailed definitions has caused disagreement between the SEC and the various US banking regulators. A rule that seemed so simple when first drafted is proving to be the most contentious section in Dodd Frank. We think now is the right time to give some thought to how banks will restructure their businesses around the Rule, what problems they might face and what systemic issues might lie in wait for the regulators of the future as a consequence of this legislation. We will consider some key questions about the Rule and its impacts, both intended and unintended.

WHAT IS THE POINT OF THE VOLCKER RULE?

If the detail isn't particularly transparent at the moment, at least the motivation of the legislators who created the Volcker Rule seems clear. The aftermath of the financial crisis was (unsurprisingly) accusatory and febrile and legislators decided to act quickly and decisively in order to quell public anger against the banks. They decided that if it was too difficult to prevent large financial organisations from being "too big to fail" then at least the Volcker Rule would ensure that they couldn't use public funds to backstop those risk-taking activities which appeared to be entirely driven by the pursuit of profits and for the benefit of their employees' pay packets. The legislators preferred the idea of cleansing the banking arena of all potentially toxic risk over a return to a Glass-Steagall type separation between commercial and investment banking activities. The legislators' motivation was clear but have the authors of the Volcker Rule gone too far in their zeal to prevent the banks from ever again building systemically dangerous risk positions?

Banks have always taken risk. To put it more strongly, banks are *in the business* of taking risk. Without risk, there is significantly less profit in banking. We may say that banks "intermediate" risk or "securitise" risk. We may not see the risk in taking deposits and making loans but the risk is there and it always will be. Credit risk, rate mismatch risk, maturity risk, liquidity risk are always present and everywhere. Market-making activities (of which more later) are full of risks: the risk that you make the wrong price; the risk that you buy when the market is going down or sell when it is going up; the risk that a client gives you such a large trade that there isn't enough liquidity in the marketplace to trade out of the position. There is no hiding from risk in a bank, nor do your shareholders or clients want you to hide. There are some banks that specialise in profitable advisory or custodial services that don't have risk at their core but, in most banks, managing risk is what makes the money.

WAS PROPRIETARY RISK TO BLAME FOR THE FINANCIAL CRISIS?

It was certainly a very big factor, but the truth is more nuanced. The starting point for the legislators was a complete prohibition on what the Financial Stability Oversight Council (FSOC) study has defined as "bright line" proprietary trading. This is trading purely for the bank's own account, maybe in a group that looks something like a hedge fund and compensates its staff in a similar way. But did these proprietary groups play a major role in causing the crisis? In the case of most banks the answer would be a resounding "no". To be clear, we are talking about proprietary groups here, the "bright line" entities, and not all of the proprietary risk that banks were taking. It is a very important distinction as we try to assess the Volcker Rule.

"Bright line" proprietary groups began to emerge in the early 1990's as the modern macro hedge funds began to grow their profits and the banks looked to emulate them. These groups were largely modelled on the big hedge funds and especially on their disciplines and metrics. These disciplines imposed strict risk and, even more importantly, loss limits on each individual trader and on each group. Breaking these limits was not tolerated, even if there are a few high-profile cases where fraudulent traders broke them spectacularly. Good performance was well rewarded but the punishment for failure was often to lose trading limits or even your job. In the vast majority of cases, it wasn't these tightly-run, highly disciplined, skilled groups that did the damage. In many cases they were the first to react to the signs coming from the US mortgage market. However, such discipline and prescience was often missing higher up the management scale.

The proprietary risk that actually brought the banks down was much more closely held. In most cases, it was managed by a very few at the top of bank hierarchies, who trusted a few elite traders to add great swathes of short-funded assets. They had felt pressured (by shareholder demands and by peer-group comparisons) into adding more and more risk, for ever-increasing profits. The years prior to the crisis brought a flood of liquidity that crushed margins in virtually every mainstream business line. Banks' growth came from adding more and more marginal, higher yield, misleadingly rated assets in huge numbers; for the most part these decisions were nothing to do with the "bright line" proprietary groups. The risks that really brought down the banks could primarily be found in SIVs, SPVs and other opaque vehicles– a world that is now being called "shadow banking".

So proprietary risk was indeed to blame for the crisis. However, this was not risk taking in the areas that the regulators have targeted. We would argue that the Rule has led to many talented and disciplined risk-takers being forced into hedge funds at exactly the time when banks most needed their experience and money generating abilities.

HOW HAVE BANKS RESPONDED TO THE RULE?

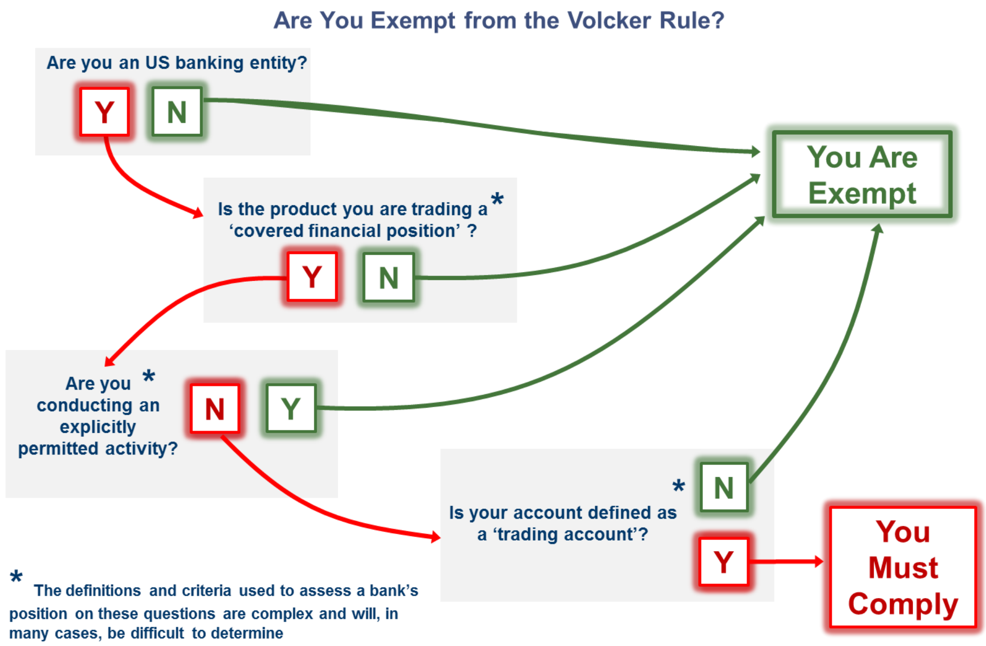
The Volcker Rule is just one of a plethora of new regulations around which banks are going to have to re-shape their business. They are attempting to reformulate their business lines whilst still dealing with a tsunami of negative media coverage and political interference. Not surprisingly, there has been extensive lobbying of Washington by the large banks. The Wall Street Journal estimates that upwards of US$330 million has been spent by the financial industry on lobbying since Congress passed Dodd Frank. The stakes are high - Standard and Poor's best guess is that the Volcker Rule alone may cost the eight largest US banks as much as US$10 billion in pre-tax earnings annually. Given that they can't entirely abandon risk, the banks are considering how to re-frame their risk-taking so that they can comply with the Rule. The first inclination of the large US banks was to shift the proprietary risk to another arena. The risk would have to leave the investment bank but could it find a home next to the bank's balance sheet under the guise of hedging or could it fit in with their asset management business, with the bank managing its own funds alongside client funds?

Unfortunately for the industry, the huge May 2012 losses in JPMorgan's Office of the CIO could not have come at a worse time. The Office managed the bank's capital and was deliberately situated outside of the investment bank. Its aggressive trades were portrayed as hedges but when one of these went badly wrong management found it difficult to justify the group's risk profile. Inevitably, the image this portrayed of big banks attempting to outmanoeuvre the Volcker Rule led to renewed demands for those drafting the regulations to root out proprietary risk. However, we think that far from vindicating the direction in which the regulators are heading, these losses paint a frightening vision of what life could look like after the Rule is in place. Remember, this will be a world in which large numbers of experienced and successful risk-takers have migrated to hedge funds and in which banks will try to continue to take risk but will attempt to do so in more covert and less optimal ways, moving away from the disciplines of mark-to-market and into a netherworld of "hedging" and camouflaging. If other banks follow JP Morgan's model, then this could be a world dominated by a few senior risk-takers running very large, sometimes illiquid positions in an attempt to replace the lost earnings from the diversified, disciplined, generally more liquid positions of the proprietary groups. These huge concentrations of risk were one of the root causes of the crisis. In our opinion, the Volcker Rule risks engineering these fault lines into the fabric of the banks.

Whilst there is a clear prohibition in the Volcker Rule against banks owning more than 3 per cent of any hedge fund, there is less clarity around "real money" funds and this is developing into another battleground between the banks and the regulators. The big banks, led by Goldman Sachs, have been lobbying for an exemption for their external credit funds. The mandate of these funds is specifically to go out along the credit spectrum in search of higher yields. The two largest of the funds run by Goldmans have total assets of US$10.5 and US$13 billion respectively, of which around 15 per cent is thought to be the bank's own money. They are admittedly lightly leveraged, largely cash funds but was it really the intention of the Volcker Rule to take risk out of the banks and concentrate it in these shadow banking ventures? If they grant an exemption in this case, there will be a serious incentive for the ever-innovative banks to grow and expand the mandate of these types of funds. In a future crisis these funds could well affect the health of the large banks with which they are connected. Our feeling is, therefore, that a future crisis originating in a growing shadow banking arena would be much more likely to cause serious systemic issues, although this potential problem is recognised by regulators on both sides of the Atlantic.

BUT WHAT ABOUT ALL THE OTHER EXEMPTIONS?

As it stands, the Rule will allow you to be exempt in a number of different ways. You can of course be exempt by not being a US company, not having a subsidiary in the US and not executing trades with US entities ("persons"). That is the easy way. Barring that and assuming you wish to do business in the US, then you can be exempt if you are trading for the purpose of hedging, underwriting new issues, market-making, for purely customer transactions or for "bona fide liquidity management". What you must not do under any circumstances is operate a "trading account", defined as an account specifically set up in order to profit from short term price movements. Unless that is you are trading in one of the following products: US Treasuries, US agency debt, US municipals, spot commodities, spot FX, repos and reverse repos or securities lending. With so many exemptions we would observe that there will still be plenty of scope for placing big proprietary bets. We want, however, to concentrate our analysis on a few of these areas and assess the potential impact of the exemption and whether they are appropriate.



The problem of defining "what is a hedge?" is well illustrated by the contortions in the case of JPMorgan's CIO office losses. However, the challenge of definition does not stop there. How about defining what is a "bona fide liquidity management" trade in the Asset and Liability Management (ALM) space? That really is going to take some unpicking. A trader might purchase some highly-marketable sovereign bills or bonds for liquidity reasons - is the Rule asking him not to consider whether these bills or bonds will go up or down in price? Say these bonds happen to be European sovereign bonds, is the Rule asking the trader not to consider the credit risk he is taking? If he did consider the other risks involved, would he then be in breach of the Volcker Rule? If the trader bought a bond position and then hedged it immediately, how does the Rule handle the fact that he is then taking basis risk? Is he supposed to consider whether he will subsequently make or lose money on that basis risk? We think that it is going to be virtually impossible for any trade in this space to be entirely for "bona fide liquidity management " and we don't think that any bank would want its traders to take such trades without considering the other risks. The whole area is a minefield. We have just scratched the surface and ALM is indeed one of the areas that the banks are trying to address in their lobbying of Washington. If the banks get some of the exemptions they are seeking, then the balance sheet may well be one of the arenas in which meaningful risk can be taken without broaching the Rule.

We understand the motivation behind the exemptions for US Treasuries, agencies and municipal debt at a time of record US deficits but these do weaken the impact of the Rule. Also, we wonder whether US legislators might have considered also exempting European or Japanese sovereign bonds as a show of solidarity in difficult times! Apart from observing that there are plenty of ways to lose money trading US Treasuries, we want to move on to the exemption that really catches our eye, which is spot FX. Note, it is just spot FX that wins an exemption - not FX swaps, nor FX options. In the pre-crisis financial markets the world was awash with liquidity and billions of dollars were chasing any viable trade. Many of the conversations we had at that time with regulators and bankers alike concerned the so-called "carry" trade in FX, which all participants worried was creating huge imbalances between the recipients of these funds and those whose currencies were being shorted. This was a simple trade. It involved buying currencies with high interest rates and selling those with lower ones and taking the rate differential, whilst all the time hoping and praying that the currency that you were long of didn't go down and vice versa. In 2005/06, whilst all was still calm in the US mortgage pools, the biggest ripples in the risk pond were caused when these carry trades corrected. Now, whilst these trades aren't hugely popular at the moment (largely because most official interest rates are so low), it doesn't take a crystal ball to foresee a time when they will come back into fashion. It seems a strange exemption in some ways, especially as it is not a product where market makers need to hold an inventory in order to function effectively.

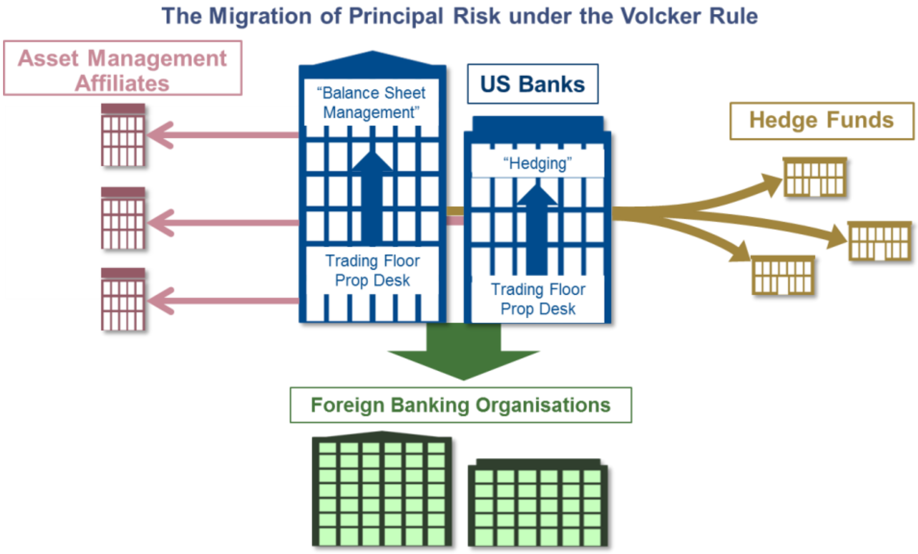
WHAT OTHER ISSUES WILL THERE BE FOR MARKET-MAKERS?

In drafting the rules, the regulators are grappling with the myriad problems of trying to differentiate what is truly a market-making trade from what is a proprietary position. They are attempting to throw the burden back onto the banks to prove that trades are market-making trades and to create a compensation ethos that purely rewards competence in servicing customers. We looked earlier at the risks inherent in market-making but we also need to think about how certain market-makers are going to function. As mentioned, it doesn't affect spot FX, or indeed IRS trading, in quite the same way, but how do you effectively make markets in corporate bonds or equities without holding inventory? The regulators have indeed recognised that there is a problem here and have tried to define exactly what will be classified as a trade done purely with the purpose of servicing the customer but the argument is similar to that with ALM liquidity trades. How does a trader hold inventory for even a short time without having a view on the market? There is a lack of liquidity in many markets which inhibits early exit from a position without significant loss. Even if the position is hedged, the trader is going to have to have a view on the basis risk involved. Would he be allowed to make money out of that basis trade? There is an exemption for underwriting new issues but what if a trader pre-positions for any other potential customer trade and then the customer decides to trade with another bank? Does he have to get rid of that position immediately as there is no justification for holding it any longer? The Volcker Rule seems to downgrade traders to brokers and seems also to be to the detriment of customers who will surely have to trade on worse prices as a consequence. There are many questions still to be answered.

CONCLUSIONS

It's not that we don't understand why many people think the Volcker Rule is a good idea. It is more that, once you start to look at the details, it is not at all obvious that the rule finds the right target, or that it will be particularly effective. Moreover, it runs the risk that it might in itself precipitate the next big financial crisis. Very large, poorly understood and poorly managed holdings of proprietary risk were the main contributors to the banks' downfall in the crisis, not the "bright line" proprietary groups. It is the ability of banks to hold these long-term pools of debt that should have been targeted. Instead, the banks have been incentivised to find homes for more of these risk leviathans and to rid themselves of the strictly disciplined risk traders who are usually best placed to see new crises coming and nimble enough to avoid the worst impacts. The new risk in the banks will be concentrated in a very few, senior hands; it may be obfuscated and deliberately camouflaged; it will cause risk management professionals all sorts of conflict because it will be outside of their remit and above their pay grade and; it may be held in vehicles that are less well capitalised, less well regulated and may very well also hold large amounts of customer funds.

Even if the combined efforts of the regulators manage to create banking systems without systemic risk we still foresee some significant potential problems. The hedge funds, which have sucked up a lot of the proprietary talent, will also absorb more and more of the risk that the banks will have to avoid. Again, the risk will reside in a more lightly regulated space. When the next crisis hits and all the positions are aligned (as there is a well-documented tendency for them to be), are the regulators really going to be happy to see multiple, large hedge funds fail? That ultimately is the point of the Volcker Rule, isn't it? To cleanse risk from the banks which are truly "too big to fail" and to move it into institutions that aren't? The crisis has taught banks to risk manage their prime brokerage portfolios much more aggressively than they were doing but they will remain the source of leverage for the hedge funds. If, in the future, the funds become bloated on the risk that the banks have left behind, are we confident that the banks' margining systems won't be overwhelmed by a cascading failure among the hedge funds?



As continued consultation has led to ever more detailed rules and the regulators try to envisage every loophole and shut it, we think it is timely to observe that sometimes less is more. The key to this legislation is surely simplicity. Paul Volcker himself seemed to advocate this in an open letter to the regulators in February, 2012 when he wrote that his sense is that "success is strongly dependent on achieving a full understanding by the most senior members of the bank's management, certainly including the CEO and the Board of Directors, of the philosophy and purpose of the regulation". We couldn't agree more. We think that the much strengthened prudential capital rules coming with Basel III will do much of the heavy lifting here as the banks will be forced into taking a more cautious, less leveraged approach in order to best utilise the capital available to them. We think it would be better if the Volcker Rule was a simple principle, bought into by the people who actually run the big banks.

We envisage a risk regime not so much based on rules to be worked around but one that recognises the centrality of risk to the business of banking that understands the true causes of the last crisis and guards against large concentrations of risk. It should do this through more pragmatic and hands-on regulation by regulators who really understand the big banks and who have been given effective powers by the legislation. We believe that the regulators' time would be better spent in ensuring that we never again get systemically threatening concentrations of risk, not trying to work out whether a market maker has made money out of holding his inventory for too long or whether a liquidity trade is "bona fide." This surely was the lesson that needed to be learnt from the crisis.

We recognise that the new banking behemoths are far too large and complex for this to be achieved without a thorough grasp of the metrics of risk. However, we wonder whether a reliance on VAR figures shouldn't be replaced by a new dialogue both between risk management departments and trading floors and between the regulators and banks. One way or another, there is much work for risk management departments (in particular) to do as they transition into a role that now also includes monitoring and policing this new and extended regulatory framework - ensuring that the banks comply. We are concerned that the risk departments are going to spend their whole time churning out ever more meaningless and backwards looking metrics when what is needed is a much more holistic approach to risk management - with risk management central to the trading floor culture and having the power to influence strategic direction, not just to monitor the results. We do think that there was an excellent opportunity missed with the implementation of the Volcker Rule that could have helped to give us a fit and thriving banking sector capable of playing a more positive central role in our 21st Century economies. As it stands, it is just another complication which diverts management energies into rule compliance without making the world a safer place.

Adsatis Ltd – December 2012

If you wish to discuss any of the views expressed in this paper or require further information, please do not hesitate to contact us:

michael.smethurst@adsatis.com