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Whitepaper: Too Many Stakes on Volcker

*By **Kelvin To**, Founder and President of Data Boiler Technologies*

The Republican's Financial Choice Act has sparked a wave of debates on the Volcker Rule. There are also many questions on what President Trump refers to as the "Modern-Day Glass Steagall Act". Treasury Department was asked to review whether existing laws and regulations follow President Trump identified "core principles" of his administration. Before Mnuchin reports back his findings by June, let's see cold hard facts and what are at stake regarding the Volcker Rule.

(1) Synching with the "America First" Principle

A key exemption to the Volcker rule specifically allows banks to continue to engage in proprietary trading in U.S. government, agency, state, and municipal obligations. This privilege is definitely synching with President Trump's "**America First**" principle. According to St. Louis Fed, "U.S. commercial banks holding of treasury and other U.S. agency securities doubled to $2.4 trillion compared to nine years ago", which is a sign that the policy is serving its purpose. It helps fill the money gap as the U.S. faces massive sell-off of treasuries from foreign creditors (see this). Americans should be pleased because this favorable policy has made the U.S. government debt less depending on foreign countries, such as China!

(2) Rejuvenating Liquidity in the Markets

I have said in the past that the fragmented liquidity issue regarding Volcker is like a Dihydrogen Monoxide Ban, i.e. hoax. The rule does discourage banks holding of infrequently trade securities, yet regulators never rule out banks holding of securities inventory over 60 days. Besides, banks are allowed to have up to 3% sponsorship (investment limit) of a hedge fund (HF) or a private equity (PE). Though these HFs / PEs are not part of the bank holding companies, many are run by major banks' former employees – Goldman Sachs in particular. Through an arm-length of alumni relationship, HFs / PEs can engage in risky bet of infrequent trade securities, while their sponsoring bank(s) earn a carried interest without violating the law. If the Trump's administration wants to give a bit more leeway, these "backdoors" may be widened (provided that credit exposures will be under closer scrutiny).

Widening backdoor is relatively **less complicated than "reinterpreting" what is proprietary trading**. CGFS-52 already provided a comprehensive definition of proprietary trading versus market-making, there is no point in reinventing the wheel! Also, the resulting effect to rejuvenate market liquidity will be immediate. I assume the folks at Goldman, HF and PE managers, and the broader market would welcome an increase in sponsorship percentage, or even removing any investment limit. The Treasury should conduct a "more rigorous regulatory impact analysis" [section 1(c) of the Executive Order] to see what magnitude of change may **create a desirable economic growth**.

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(3) Divergence of International Financial Regulations

Regulators around the world are looking to achieve the same goal – "**taxpayer-funded bailouts should be prevented**". Yet, each country has some variations in implementation. Thankfully, American banks are not at any disadvantage compare to their foreign counterparts. Foreign banks with operations in the U.S. must also comply with the U.S. Volcker Rule.

Mercy to these foreign banks because they are subjected to their home country rules (e.g. Vickers ring-fencing requirements for the UK, Liikanen's proposal of "subsidiarization" for the German and French) on top of the U.S. laws. Synchronizing this part of the international financial rules is next to impossible in the near-term. Unless foreign banks can afford to lose the U.S. market (which I highly doubted, or the "foreign exclusion" requirements of Volcker are too harsh), they have no better option but be scrutinized twice. This meets President Trump's goal of "**enabling American companies to be competitive with foreign firms**".

In order not to upset the American allies, the Volcker rule has been crafted carefully in permitting proprietary trading in the obligations of a foreign sovereign or its political subdivisions under "special circumstances". Frankly, the Canadian's treasury bonds have better yields than the U.S. T-bills. The privilege treatment as mentioned in (1) is indeed a skewed policy that prioritized American interests. This "special circumstances" clause under Volcker gives the U.S. adequate leeway for "**international financial regulatory negotiations**".

(4) Mixed bag of Effectiveness and Efficiency

Per OCC analysis of 12 CFR Part 44, there are about $66 billion of impermissible assets held in the U.S. banking system. One should consider the regulatory impact to the broader economy before off-loading these risky assets. The situation is similar to the massive non-performing loans held by Japanese banks since their banking crisis in year 1991 (see this). Holding on until asset values improve seems to be the tactic for many central bankers around the world. No-one likes to be blamed if the sell-off may trigger another downward spiral to the economy. In the case of U.S., the Federal Reserve has provided a regulatory relief/ 2022 extension for bank ownership of covered funds. The purpose is to allow for a stable run-off of these troubled assets, despite there are heavy criticisms by the Democrats. To evaluate whether this "**extension**" **policy is efficient and effective**, let's look at the case of China.

The Chinese communist government has set up a separate entity to park aside some of their banks' non-performing assets. Because of accounting differences with the U.S., these problem loans are hidden from the Chinese banks' books. By turning a blind eye to their problems, Chinese banks continue to provide liquidity to the market. According to the Huffington Post, "bad loans keep piling up at China's biggest banks hence they are trading at a discount between 15 to 25 percent from their book value". U.S. also deferred to deal with toxic assets until later years. However, problem is contained rather than letting it grows. Applaud to the Fed that taken a more restrain and long-term view to our country's financial policy. As a result, we are seeing U.S. financial stocks trading at 30 plus percent premium to their book value.

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The most ineffective and inefficient part of the Volcker Rule resides with the metrics. For example, "inventory turnover days" for derivatives are likely to be zero, and it doesn't make sense to blend-in / average-out with other assets. Banks also face computation challenges, including the determination of stress period, dynamic re-calibration, and all sort of problems related to VaR measurement. Though regulators may use the "guilty until proven otherwise" clause to bring charges to banks, but they seems not familiar with that power or hesitated because their prescribed metrics aren't effective to prove a bank's trade activities may be in compliance or violations. Changing up these metrics won't be helpful because no static metric report would serve as proper "qualifier" of the various Volcker exemptions (i.e. underwriting, market-making, risk mitigating hedges, liquidity management). To efficiently discern for possible violations and prevent rogue traders from using synthetic created trades to by-pass controls, all trades ought to run-through algorithmic checks, just like emails having spam filter.

(5) Appropriate Reliefs and Tailored Incentives

Smaller banks argue that they have minimal trading activities thus asking regulators to preclude them from compliance with the Volcker Rule. I can see the smallest community banks with less than $10 billion in consolidated assets making such argument, and they are already exempted. Should the **threshold be increased** to $20-$40 billion, I think the Republicans can make a good case for it. In fact, regulatory policies should not be fueled by Fascism hatred of particular top player(s); otherwise it will be detrimental to the openness of our capitalistic economy.

I disagree on making the Volcker Rule only apply to the top 10 or 12 G-SIBs (Global Systematically Important Banks). **A healthy market needs more diversity of players**. The more stringent the rule, the more it'll push the industry into further consolidation. Smaller banks cannot justify the heightened regulatory compliance costs on their own but to seek mergers and acquisitions. Therefore, one should consider appropriate incentives (e.g. reduce capital requirements) to **motivate the medium and small players to improve their risk management capabilities**. In return, those banks may subject to additional scrutiny using a regulator designated automated surveillance system (possibly an evolution of CAT) to validate the effectiveness of their control improvements. Consequently, they will become more effective to compete in the market and increase diversity (i.e. **choice**). Well-run tier 2 banks will then be ready to take over business of poor run large G-SIBs – this indeed may be the most **effective way to curb TBTF** (too big to fail)!

(6) Avoid Policy Mistakes and Modernize the Rules

I don't disagree that banking is alchemy. If use appropriately, it can transform risks and maturities (e.g. borrow shorts and lends long) to positively serve the economy and create wealth. However, abusive use of financial engineering (e.g. synthetic created short sales that may otherwise be impermissible) could result in problem being hidden until it gone haywire to affect the broader economy. As mentioned in (4), **metrics aren't effective way to curb misbehaviors in the modern era**. Stop using flawed metrics to dictate how a bank should be run – this is the number one thing to avoid policy mistakes. Second, "reasonableness" of activities depends on "market timing", not some static documents or policies. Therefore, regulators should **stop allowing banks to regurgitate risk appetite statements as RENTD** (reasonable expected near-term demand forecast).

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Regarding the modernization of the rules, below I suggest a 3 prong approach to **use engineering methods to address financial engineering problems**:

(a) **Remove 79 FR 5592 – Footnote 711 of Volcker**, so it'll synchronize with the SEC's consolidated audit trail project for a transaction-by-transaction scrutiny on abusive use of securities inventory (see this). The process should be robust, like a spam filter running behind an email system to avoid undue burden. It'll help address the issue of banks taking excessive market risks.

(b) **Monitor market risk versus credit risk exposures**. Banks shouldn't undertake excessive credit risk to make up for revenue loss caused by Volcker's mandate to reduce market risk exposure. Yet, this success story of Barclays offers an interesting perspective: quality exposure to consumers' credit card portfolio can be an effective hedge against the downturn of a bank's securities business performance. Banks should embrace modern portfolio theory to use diversification to help reduce volatility. The tricks are: (i) the exposure has to be selective and suitable for banks; (ii) watch out if both market and credit risk exposures headed south at the same time; (iii) pull in healthy peer bank(s) to help and avoid peers in the same boat of stress; (iv) regulators monitor for possible contagious concerns.

(c) **Enforce appropriate behaviors of market makers.** Reg. NMS has caused a proliferation of nuances that gives rise to non-bank HFTs (high frequency trading firms). They become passive market makers in capturing market surplus using their speed advantages. However, it is uncertain that they'll stand ready to provide market liquidity in both good and bad times. Policy makers should heed the advice of the Federal Reserve Chair Yellen: "make sure that investment banking activities where -- that were a core part of the SHADOW BANKING SYSTEM where leverage had built, that those were appropriately capitalized, had appropriate liquidity and their management was strengthened." In other words, curb risks outside of the banking system and restore orders in the markets.

(7) Restore Accountability with Federal Agencies

The Volcker Rule was approved by 5 federal agencies (Federal Reserve, SEC, CFTC, OCC, and FDIC). This signifies that **modern day financial challenges can't be solved by silos**. It calls for their collective efforts to craft the rule and coordinated regulatory actions for appropriate enforcement. Sadly, our observations are the complete opposite. OCC is the only agency comes up with an interim exam procedure, while the Federal Reserve has put together some FAQs. If the SEC's approval of consolidated audit trail project may count toward their contributions/ updates of market surveillance approach, then why it misses CFTC's participation to include futures data? We acknowledge that CFTC does work on the controversial swap rule (title VII) and Reg. AT. Lastly, FDIC is supposed to be the main driver of Volcker because speculative risks are uninsurable for FDIC insured banks. Instead, they focused on the living wills for which it has been called the "murky guides".

With full respect to **FDIC** Vice-Chair Hoenig's 40+ years of experience as regulator, but his latest speech is the most **backward thinking contrary to the advancement of modern regulatory supervision**. To quote him, he calls for a "return the safety net to its original purpose—that of protecting the payments system and the depositor." Banks aren't merely payment processors and deposit takers in the 21st century! It is better for banks to play the market maker role in serving the economy, than pushing investment banking functions out to the shadow banking system and

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HFTs (see point 6(c) above). Hoenig simply passes the buck to let other agencies deal with modern days' financial engineering problems. His suggestion to partition commercial and investment banking activities by creating separate legal entities only benefits law firms.

Modern day financial industry biggest supervisory challenges arise from things happening too fast and changing so dynamically. Investigation is a pain, and it is hard to reveal what's going on by using the old school surveillance process. Regulators should **foster the industry's advancement in risk management practices** (e.g. implement preventive risk control in real-time, active surveillance). Mandate those who are majoring in the minors (i.e. crafty policies and procedures but lack substance/ effectiveness in enforcing controls) to **deliver concrete improvements**. And recognize that continuous heightening of capital can be a two-edged sword to the overall health of the financial system (i.e. further consolidation of banks and adversely pushes risks into less regulated shadow banking system).

Blindly following Basel's suggestions won't be helpful for the U.S. in international financial regulatory negotiations and detrimental to American banks' competitiveness. This whitepaper has illustrated that the Volcker rule has in-large synchronized with President Trump's core principles. Too many are at stake on Volcker. Rocking it may severely affect the broader economy, especially on the privilege treatment of U.S. Treasury. Changing up metrics won't be helpful to effectively curb misbehaviors. I urge the 5 federal agencies to accelerate their enforcement and fine turning of Volcker as suggested. I also encourage Treasury Secretary Mnuchin to consider my 3 prong approach in **balancing the right industry developments with fulfillment of 21st Century Glass-Steagall's objectives**.

*** END ***

P.S. *Scan the QR code or click here to see* ***Progress of Volcker Rule Implementation***

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