☏ 617.237.6111
✉info@databoiler.com
DataBoiler.com

Reasonable inventory and I **can't** see it

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

Has anyone seen the OCC analysis of 12 CFR Part 44 (Volcker Rule) lately? It seems to be removed from the OCC's public website, but I have saved a salvaged copy here. There is supposed to be substantial compliance emphasis associated with the Reasonably Expected Near-Term (Customer) Demands (RENTD)/ Securities Inventory Plan per OCC's estimate. Presumably, banks should have in place "reasonably designed" compliance programs to enforce the appropriate RENTD limits by July of last year.

Yet, there still is headline news like this: "CEO blindsided as bank added to risky position"? Who was "**blindsided**", or should the incident be considered as an excess of RENTD limits? Is RENTD/ Inventory, a cornerstone concept mentioned 581 times in the final rule, a taboo or no longer of any significant?

Many in the industry are against the Volcker Rule, but **I see** merits in it because RENTD requires banks to maintain a healthy balance of securities inventory. Let's put aside the overshadowing arguments of "too big to fail" (TBTF) that often affiliated with the Volcker Rule in popular news commentaries – I indeed think the major focus of Volcker should be about "**reasonable inventory**" and ensuring market makers won't be exploiting or abusing the information advantage. Per Steven and Steven's empirical research, "a market maker receives less for trade execution when he or she is making a well-timed trade". Instead of fixing this market structure issue, rule makers ditched proprietary trading entirely. If RENTD isn't set to only permit the "**right amount of trades at the right time**", then how would anyone know if trades may be abusive? How can banks do anything to curb rogue behaviors that could cause huge losses in lightning speed?

I don't disagree that banking as alchemy. This alchemy if used appropriately, can transform risks and maturities, making it possible to borrow short (e.g., on demand deposits) and lend long (e.g., mortgages) to positively serve the economy and create wealth. Similarly, some calls asset securitization alchemy, but securitization **doesn't necessarily need to be associated with negative connotations**. Securitization was introduced to make banks safer by off-loading risky assets and spreading the risks across global investors whom have the appetite to earn a reasonable return on these assets. Think about the toxic mortgages (or dream houses of Americans prior to the crisis), what if risks weren't thinly spread across the World to foreign countries, like China, Singapore, Germany, etc.? If there weren't those **innovative financial instruments**, it could be catastrophe for American if risks were fully retained domestically in 2008.

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In my opinion, the financial instruments used to transform risks are neutral in terms of consumer protection. It only **becomes problematic when someone abused it to seek proprietary gain**. Is it wrong for retirement funds/ endowments to demand for low risk products with irrationally high returns to fulfill their obligations to beneficiaries? Is it wrong for banks that sold securitized instruments to these funds and endowments to retain a portion of these assets to have skin-in-the-game? Are underlying mortgages with sharp rising delinquency rate reasonable? Was it reasonable for AIG and others to irresponsibly borrow their credit rating to guarantee these toxic assets, in exchange for earned fees that came at almost no cost to them? **Who was blindsided** by the wishful thinking that Americans can own their dream houses without putting in sufficient down payments? **It all boils down to one word – "reasonableness".**

Did bankers know there was a moral hazard issue with the mortgage market before 2008? Did they care when someone else guaranteed the instruments? Most bank employees were trained with the "can do" attitude. When the market kept asking for more and more of those toxic assets, banks did not stop supplying them. **Saying "no" at that time would be so unpopular** because it was perceivably against the American dream. Don't blame the alchemists/ financial engineers whom invented these securitized instruments. Ask who lacked the gut to say "no" at time **when market economy is not working**.

Sadly regulators aren't sticking to their guns or have misinterpreted the "true intent of Volcker" when faced with the industry pressure. The agencies "are not adopting a transaction-by-transaction approach" to security inventory in the final rule (see 79 FR 5592, Footnote 711). RENTD without a transaction-by-transaction analysis to qualify exemptions is indeed opening the backdoor for rogue traders to use synthetic finance to create trades to circumvent controls. Fortunately, there is the **backstop** provision to serve as a **catch-all clause** to address "anything that may become a threat to the U.S. financial stability". However, Massari and Rosenberg argued: "in practice the backstop approach accentuates the drawbacks of each of the descriptive and prescriptive approaches, rather than their benefits, **resulting in ex ante uncertainty while tying the hands of regulators**."

As there are enforcement and implementation challenges on Volcker compliance, many banks demonstrated a backburner behavior to **turn a blind eye on the rule**, or treat it as second priorities. The industry vastly makes a choice between two equally unpleasant alternatives: (1) shutdown and retreat; or (2) muddle through with settlement negotiations. Option 1 does not work because **shutdown does not mean qualify for exemptions**, and retreat diminishes bank's ability to transform risk and create liquidity.

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Over divesting of financial assets is different from the "just-in-time" manufacturing concept of zero inventories. An overly dried up of market liquidity could be detrimental to the U.S. financial stability. Option 2 is worst, because it is a slicky way that a bank may **pay settlements and treat the costs as a "lesson learned"** to limit the scope of what needs to be done. Short-sighted managers may let others face the consequences years after. It comes with huge reputational risk, and continuous lawsuits will divert the bank's focus.

Amid the convoluted twists to "reasonable inventory"/ RENTD, I **can't see** how banks may effectively enforce policies and procedures for Volcker compliance if they don't implement real-time preventive risk controls to enable their middle-office to match up with the front-office. I **can't see** much meaning in Volcker metric reports when added risky positions aren't tightly managed against RENTD using the "instrument approach". I **can't see** regulators using a vulnerability scan to evaluate market makers' inventories as reasonable or not, while they should at least verify if market makers are performing their duties to provide liquidity in both good and bad times as suggested by the SEC.

I **can't see** a restoration of reasonable market liquidity because many market makers have fled or merely providing phantom liquidity. I **can't see** the consumers being better protected against rogue behaviors that use synthetic-created trades to bypass controls, and it may be too soon for politicians to declare victory over the Wall Street. Nobody, except lobbyists and some advisory firms, benefits from this bureaucratic situation. **Do we want to be "blindsided" to leave the matter to the next crisis?!** Convince me that "reasonable inventory" can still be seen if you care.

