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Volcker Rule: Dihydrogen Monoxide Ban?!

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It is the final days before the Volcker conformance deadline, and many are still in denial, accusing that the rule kills market liquidity. Is there really a problem with the proprietary trading ban, or is the industry having an issue likes the "dihydrogen monoxide" ban? Click here if you never heard of this hoax that involves simply calling H_2O (i.e. water) by the unfamiliar chemical name "dihydrogen monoxide" and listing some of water's effects in an alarming manner to illustrate how the lack of scientific literacy and an exaggerated analysis can lead to misplaced fears. In other words, the rule itself may indeed be neutral.

This whitepaper uses various market observations to review whether the rule has ripple effects on liquidity since the industry is in fear of or have misunderstandings about the rule. Also, it unveils whether there is any substance behind risk control and financial stability improvements. So here are some of the observed industry's stances or preparedness for Volcker:

1. Banks claim compliance with the Volcker Rule using strong statements, such as: never engage in proprietary trading, or proprietary desks have already been shut down…
   This self-claim of compliance due to shutting down proprietary trading desks would not satisfy regulatory requirements. Shut down does NOT mean qualified for exemptions. The rule states that banks are "guilty until proven otherwise". Shutting down proprietary trading desks is no excuse for not subjecting all trades to rigorous testing in order to "qualify" for the necessary exemptions. Rogue traders can use other desks to game the system if there is no proper control. Therefore, this is not an improvement of risk controls but a necessary conformance step ordered by the rule. Reduce market activities is a logical consequence "if" other players (entities not covered under Volcker) aren't assuming a bigger role.

2. Banks put comprehensive policy frameworks and procedures together and tightened risk limits …
   Policy frameworks and procedures are all good as long as it can be enforced. It is humanly impossible to manually monitor millions of trades in real-time where losses can be accumulated in a split second. If your controls aren't quarantining prohibited trades in real-time, then it shouldn't be considered as a "preventive" risk management system (see related articles: Spam Filtering the Prohibited). Your tactics to tighten trade appetite

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are NOT a substitute to the requirement of having a "preventive system". At the end of the day, would CEO and CCO be attesting to empty boxes?

3. Some banks are in denial, arguing that they are not G-SIBs when they don't have market making and only have limited trade activities …

Though smaller banks may neither have market making nor underwriting, they still have risk mitigating hedges and a treasury-desk for liquidity management. The call of unfairness in subjecting community banks to the same rule as those G-SIBs is acknowledged. However, regulators are like "overprotective parents", concerned if anyone may bypass the controls (see related articles: Volcker's Intent is Hacked and Leaked).

Tier 2 and smaller banks need help to bear the costs of improving risk controls. Building a risk and compliance utility model allows costs to be minimized and shared by participant banks. The running costs of this shared system would then be funded by a small toll-charge for things being successfully quarantine or qualify for the appropriate exemptions. This is indeed Tier 2 and smaller banks' opportunity to up their game in sales and trading with the enhanced risk management capabilities. It is either go big with improved risk management capabilities or go home, i.e. cut assets below $10 billion.

4. Banks use a "risk-based" approach for RENTD, or limit securities inventory to no more than 60 days …

"Risk-based" approach to Volcker inventory was being advocated in the past, quoting 79 Fed Reg. 5592 as backing argument. In fact, 79 Fed Reg. 5592 shouldn't be inappropriately inferred because footnote 716 mentions "principal" exposure as inventory, not "risk" exposure. This is a red flag that regulators should be concerned with as someone may be trying to game the controls. For example, "If" trading desks are allowed to use "any" instruments they like (as long as the instruments are sensitive to the risk parameter under their so called "risk-based" approach), this essentially will provide the possibility to synthetically create trades that would otherwise be prohibited using multiple instruments.

Another seemingly false teaching is the "60 days haircut" approach to inventory. Correct me if I am wrong, but regulators never rule out inventory over 60 days. Although "60 days" is usually used as a benchmark for near-term transactions, but that is not set in stone. Just like there are bound to be people with size 18 feet that needs size 18 shoes, we have to cater for outliers. There are formulas that we can help to rightly justify those infrequent trade instruments for the securities inventory plan. In fact, traders are also looking for the incentives

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to carry those long-dated inventories, thus expect related trading costs to rise or else there won't be a return of liquidity in those segments.

5. Banks recalibrate risk models quarterly, and RENTD is jointly set by risk and trading teams quarterly.
   Applause for the good practices to review and recalibrate risk mitigating hedges regularly. In fact, everyone knows the markets are dynamically changing every single day if not faster, and definitely faster than every quarter. To qualify for risk mitigating hedge exemptions, please be mindful of the rule highlighted as follow: per §_5(b)(1)(ii) "… on-going monitoring …", (iii) "… independent testing … correlation analysis …", (2)(ii) "At the inception of the hedging activities …", (iv)(C) "Requires ongoing recalibration …". Exposure can be accumulated quickly if prohibited trades are artificially claimed as risk mitigating hedges. Therefore, all preventive measures have to be done on a play-by-play basis, or else it'll leave room for rogue traders to game the controls.

   It is also true that RENTD/ security inventory plan should be done dynamically on a play-by-play basis. Using static "governance document" to state what are or are not allowed to trade is not considered a "forecast". RENTD/ securities inventory plan forecast and reforecast should reflect who the banks are and demonstrate how their trading desks respond to market changes, clients' appetite changes, instruments' payoff and risk convexity changes, etc. It goes beyond a generic trade appetite of doing "X" millions of trades in Y instrument every week under a normal market condition. It also includes a RENTD stress trigger, on-going monitoring of event-driven factors, rationales to justify any deterministic factors, and why history is or isn't a good projector of the future, etc.

   Think about it, nobody want the regulators to use one "generic" template to measure if a bank's RENTD/ security inventory plan is or isn't out-of-whack in comparison with other banks. Therefore, this is your opportunity to show the regulators your unique differences in trading desk nature, your trading specialties in certain markets and/or instruments, and substantiating your "reasonable" trade appetite.

6. Banks devoted a lot of resources to preparing metrics for the regulators, and that is hard given their global scale.
   Of course it is hard to do metric reports on a global scale. It is even harder when it involves manual regurgitation from multiple data sources. This is so backward because reports are supposed to be the end-product of a robust

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system. An untimely report can at most be used for historical trend analysis. It would not prompt banks for immediate attention and timely actions to respond to a potential threat. So this is like major in the minors.

Besides, the Office of Comptroller of Currency was expecting banks to devote the majority of resources into RENTD. Per analysis of 12 CFR Part 44, there is supposed to be a new headcount for each of the 1591 trading desks from the top 46 bank holding companies in the US. Where was the billion dollar budget spent on? To lawyers or big consulting firms for policies, procedures and reports, or was it used to cover the last regulatory fines? If efforts are not sufficiently channeled into determining "reasonableness" of trade activities, the adverse consequences would be resistance and reluctance to do any trades. "Fewer trades, fewer chances of errors" is just the wrong mentality towards Volcker compliance.

In conclusion, worries of dried up or fragmented liquidity, like the "dihydrogen monoxide hoax," are often driven by panic and fear that paralyze people's ability to think and act wisely. Instead of feeling down or listening to seemingly false teachings, put your faith and energy into understanding the unfamiliar concepts of "securities inventory" and the true meaning of Volcker compliance. Then, you'll rejoice with enhanced risk controls, which is the best collective response to the regulators. What more can they ask for! Ultimately, it will foster a safer market environment with more healthy trade activities.

About Data Boiler Technologies, LLC:

Data Boiler Technologies, LLC is a FinTech pioneer that brings big data to bear on big problems in the financial services industry. We are taking things to a whole new level with VR Machine for the Volcker Rule compliance. It is a patent pending utility to spam filter the prohibited. It helps firms determine the reasonable expected near-term demand (RENTD) and qualify for the appropriate exemptions. To learn more, please visit us at www.databoiler.com.

Kelvin To, Founder and President

Over 20 years of experience in strategic planning and corporate development with a strong emphasis on Business Modeling and LEAN Six Sigma. Kelvin has proven success at Citigroup in formulating a 500+% growth model by leveraging Big Data analytics. Prior to his current role, he was VP for Broadridge, Functional Head for Citigroup, subject matter expert in corporate finance for the Institute of Bankers, and also lecturer for various professional organizations. Kelvin holds a MSc degree in Banking from City University, a Master of Management from Macquarie Graduate School, and a BSc degree in Accountancy from Bentley University.