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Intended And Unintended Consequences Of The Proposed Volcker Rule

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ABSTRACT

Regulation is intended to protect the vulnerable. However, in its present form the unintended consequences of the proposed Volcker Rule has the potential of continuing the liquidity crisis that aided in the degradation of the housing market into decreased liquidity in the capital markets. In addition to increasing costs to the investor and decreasing market efficiency from increased bid ask price spreads, the proposed rule will transfer risk to less regulated financial institutions as new hedge funds open. The risk can have a profound impact on the retirement community through underfunded pension funds searching for absolute returns. Another unintended consequence of the proposed Volcker Rule is how the rule may place banks conducting business in the United States or with United States “residents” at a competitive disadvantage due to lost revenues combined with the high cost of compliance. The rule has the potential to cause United States banks and businesses to be at a competitive disadvantage in global markets.

INTRODUCTION

The prohibited practice of proprietary trading and the allowed practice of market making will be discussed in the first section. The proposed Volcker Rule will have the effect of decreasing revenue while simultaneously increasing costs for compliance. The capacity to compete in the global markets for covered banking entities and for U.S. businesses will decline.

Relationships with hedge funds and private equity funds are discussed in the second section. Risk is transferring from the more regulated banking entities to the less regulated asset managers and insurance companies. Herding may be a reason for concern, as well as the transfer of risk that will place many, including vulnerable retirees, at increased risk. Pension funds are underfunded and are investing in hedge funds for absolute returns.

PROPRIETARY TRADING AND MARKET MAKING

The Volcker Rule

The proposed Volcker Rule consists of 298 pages. A complete copy of the draft of the rule released by the Federal Reserve can be located online. The rule’s official name is “Prohibitions And Restrictions On Proprietary Trading And Certain Interests In, And Relationships With, Hedge Funds And Private Equity Funds” (Federal Reserve, 2011). It has been named the Volcker Rule after the former Federal Reserve Chairman, Paul Volcker (Mehta, 2011).
The Volcker Rule draft that was released on October 11, 2011 has two main prohibitions. First, the rule “prohibits [federally] insured depository institutions, bank holding companies, and their subsidiaries or affiliates [banking entities] from engaging in short-term proprietary trading of any security, derivative, and certain other financial instruments for a banking entity’s own account, subject to certain exemptions. Second, it prohibits owning, sponsoring, or having certain relationships with, a hedge fund or private equity fund, subject to certain exemptions,” (Board of Governors of the Federal Reserve System, 2011).

The first purpose of the proposed Volcker Rule is to protect customers from losing their deposits through the financial firm’s trading that involves risk for the firm’s own benefit. This type of trading is known as proprietary trading. The second purpose is to lessen systemic risk within the financial system.

Proprietary Trading is defined in the Financial Dictionary by Farlex (2011); “Proprietary trading (also "prop trading") occurs when a firm trades stocks, bonds, currencies, commodities, their derivatives, or other financial instruments, with the firm’s own money as opposed to its customers’ money, so as to make a profit for itself.”

Market making provides liquidity in the markets and increases market efficiency. The definition of market making by Farlex provides further insight into how difficult it can be to identify the difference between proprietary trading and market making. A market maker is, “a dealer available to trade a stated security on its own account at any time at the quoted price. The job of a dealer is to be a market maker in order to promote liquidity for a security. When a broker-dealer makes a market, it trades from its own inventory, which is easier and less expensive for an investor than looking for other brokerages willing to trade. Many exchanges designate a market maker for each of its listed securities to promote ease of trade. Market makers improve the efficiency of markets by quoting both bid and ask prices of an asset.”

A debate is forming in the public sector regarding the unintended consequences of the rule. The draft is open for public comment on the Federal Reserve’s web site until January 13, 2012 (Board of Governors of the Federal Reserve System, 2011). Whether or not the regulation is finalized, the statutory Volcker Rule prohibitions will go into effect on July 21, 2012 (Davis Polk & Wardwell LLP, 2011).

**Decreased Revenues**

The intended results and the unintended consequences of the proposed rule follow Newton’s well-known third law, “For every action there is an equal and opposite reaction.” Integrated into the Volcker Rule, without specific comment, are the consequences of decreasing revenue while simultaneously increasing costs.

The loss in annual revenues by financial institutions affected by the rule will be significant. Patterson and Zibel (2011) quote analyst estimates of $2 billion in lost revenue. The removal of the source of revenue is occurring at a time when banks are already under pressure from substantial costs and weak growth.

Touryalai (2011, Oct 7) provides partial details of revenues at risk. Goldman Sachs’ has 48 percent principal trading revenue at risk, although the Nomura analyst Glenn Schorr is quoted as saying the rule will impact 20 percent, which is still a substantial loss of revenue. Morgan Stanley will also feel the effect
of the rule with up to 27 percent of its principal trading revenue at risk. Bank of America has 9 percent at risk, JPMorgan Chase has 8 percent at risk, and Citigroup has 5 percent at risk.

Nomura’s analyst, Schorr provides clarity to unintended consequences of the rule in his following statement, “A draconian form of the Volcker Rule will likely have unintended consequences, such as reduced liquidity, higher funding costs for U.S. companies, less credit for small businesses, higher trading costs and lower investor returns, less ability to transfer risk, and competitive disadvantages for U.S. banks relative to foreign banks. We are hopeful regulators are mindful of these risks and doing their best to write fair, yet effective, rules.” (Touryalai, 2011 October 7).

**Increased Costs**

Costs will be increased by the Volcker Rule, knocking the revenue and cost equation further out of balance during a weak recovery. Touryalai (2011, Oct 12) quotes Frank Keating, president of The American Banker Association (ABA):

> “Only in today’s regulatory climate could such a simple idea become so complex, generating a rule whose preamble alone is 215 pages, with 381 footnotes to boot. How can banks comply with a rule that complicated, and how can regulators effectively administer it in a way that doesn’t make it harder for banks to serve their customers and further weaken the broader economy?

> It’s clear from the proposal that many important details remain unresolved. More questions are asked than answered, with requests for public comment on 394 specific issues. The exceedingly high number of unanswered questions betrays the frustration regulators are having as they come to grips with the complexity of the concepts behind the Volcker Rule when applied to reality. Regulators will be working on these practical questions for a long time to come...Regulators’ own estimates indicate banks will have to spend nearly 6.6 million hours to implement the rule, of which more than 1.8 million hours would be required every year in perpetuity. That translates into 3,292 years, or more than 3,000 bank employees whose sole job will be complying with this rule. They will be transferred to a role that provides no customer service, generates zero revenue and does nothing for the economy.”

The government estimates that the cost for compliance and capital to banking entities covered by the rule will only reach $1 billion. However, the office of the Comptroller of the Currency (OCC) estimates the cost of capital alone will reach $917 million (Brush, 2011).

Many consider these estimates to be low. Donald Lamson who once worked for the OCC as assistant director and is now a Washington-based counsel at Shearman & Sterling also believes the government’s calculation is too low. Lamson emphasized the miscalculation of the cost associated with the rule by stating, “There are a number of costs associated with this and I think the rulemaking and official government assessments understate the costs,” (Brush, 2011).

Schorr estimates the cost to the industry for compliance and monitoring will reach $2.1 billion each year (Mehta, 2011). After adding this cost to the $2 billion in lost revenues and before considering the impact
of increased capital requirements, the annual impact of the rule is estimated at $4.1 billion – during a weak economy.

When the proposed application of the rule is reviewed, the reason for the higher estimates for the cost of compliance is clear. Regulatory agencies suggest using 17 metrics in the process for determining if a bank has engaged in market making or in the prohibited practice of proprietary trading (Mehta, 2011, Oct 16). Davis Polk & Wardwell LLP Law Firm (Davis, Polk & Wardwell, 2011) created a series of flowcharts to explain the Volcker rule. The flowchart that demonstrates the complex metrics used to determine the difference between market making and proprietary trading can be found in Appendix A.

Mehta (2011) writes in her article about the additional costs that will be incurred by the need to hire new compliance employees. Daily calculations running the 17 metrics will be required of firms with more than $5 billion in trading assets and liabilities. The results are to be reported to regulators monthly. Thirteen firms fall into this category and account for 98.4 percent of the trading assets and liabilities of the 1,020 bank holding companies that are to be regulated by the rule. One compliance person will be required in each subsidiary and trading unit to meet the required monitoring for the rule. Each bank may have a multiple of a dozen trading units. To comply with the rule, a multiple of a dozen additional jobs in the compliance division would be required.

Middle sized banks will be required to measure eight of the seventeen metrics, and the small sized banks will be exempt. The smaller scale would make the costs prohibitive for the added monitoring.

Impact on Investors from Decreased Market Making Activity

The impact of the Volcker Rule will not be limited to banking entities. Investors will be impacted with a meaningful unintended consequence if the rule is applied too restrictively regarding proprietary trading and market making. Liquidity will leave the markets due to the rule’s lack of clarity.

The Financial Industry Regulatory Authority (FINRA) defines itself as an advocate for investors that maintains fair markets and, most importantly regarding the Volcker Rule, it proactively addresses “emerging regulatory issues before they harm investors or the markets,” (FINRA, 2011). Thomas Gira, Executive Vice President of FINRA is quoted by Mehta (2011) as saying the Volcker Rule has the “potential to impact legitimate activity,” and that what constitutes market making is a “difficult question to get your arms around. From a surveillance standpoint, this is a pretty challenging rule,” (Mehta, 2011).

Jamie Dimon, Chairman and Chief Executive Officer of JPMorgan described the importance of banks acting as market makers for investors during a conference call; “The United States has the best, deepest, widest, and the most transparent capital markets in the world, which give you, the investor, the ability to buy and sell large amounts at very cheap prices. That’s a good thing. I wish Paul Volcker understood that.” (Mehta, 2011).

David A. Viniar, Chief Financial Officer of Goldman Sachs, and James Gorman, Chief Executive Officer of Morgan Stanley, are shutting down their proprietary trading divisions in compliance with the rule. They too, are concerned about losing capacity for making markets and warn that if the Volcker Rule is
interpreted too strictly, banking entities will see their capacity for market making reduced. The investor will ultimately feel the impact when market liquidity is reduced (Brush, Harper, & Moore, 2011).

Lost Capacity for Banks and Businesses to Compete

Another meaningful unintended consequence of the proposed rule is how it will decrease competitiveness by all entities impacted within its scope. The proposed rule will give the advantage to foreign banks that will not have any involvement with United States financial services covered by the rule. Peter Nerby, a Moody’s Investors Service analyst, observes that, “The rule disadvantages the important core market-making franchises of the big United States banks and creates opportunities for unregulated competitors, such as high-frequency trading firms, and the non-United States operations of foreign banks,” (Panchuk, 2011).

While speaking on a panel hosted by New York University’s Stern School of Business in September, the chief executive officer of JPMorgan’s investment bank, James (Jes) Staley commented on the regulators’ observance when the Volcker Rule was first introduced. He said assurances were made that other countries “would fall in line, but we haven’t seen that. Germany, France, China, Brazil. They didn’t follow us,” (Touryalai, Oct 12).

The rule covers all banking entities that fit the guidelines, whether they are United States owned or foreign owned, and its scope continues beyond the shores of the United States. Landy (2011) summarizes how the rule expands its jurisdiction into other countries. First, to avoid impact from the rule, no party to a trade may be a United States “resident,” which includes United States companies. Second, no person in the United States may be directly involved in the trade, including employees of non-American banks that are operating within the country. If any of the conditions exist, the banking entity must comply with the proposed Volcker Rule, whether domestically owned or foreign owned.

The third part of Landy’s summary states that to avoid falling under regulation by the Volcker Rule, a trade must be “executed wholly” outside of the United States. No part of a trade may be executed by any banking entity, clearinghouse, stock exchange, or any other entity that is a part of the United States financial system.

The last point of Landy’s summary is that if the banking entity falls within the scope of the rule, every trade must be proven to comply through documenting, reporting, internal controls, and certifications. These restrictions will cause jobs to leave the country as foreign owned banks move their offices and branches out of the United States.

In addition to causing jobs to leave the United States, competitiveness of United States companies will decrease in the global markets due to the higher costs associated with financing. It can be concluded that given the high costs associated with compliance with the Volcker Rule, rather than adding new, non-revenue producing jobs to enforce the United States rule, foreign banks may elect to avoid working with United States customers. At minimum, the cost of credit will increase substantially. An example that points to this conclusion is how difficult it would be for European banks to absorb the lost revenues and
increased costs from the proposed rule during the financial and euro crisis currently taking place in the European Union.

If enforced, the proposed rule will place United States banks as well as United States businesses at a distinct disadvantage while competing in the global markets. The competition in the global markets will shift away from United States banking entities and companies.

**Proprietary Traders Exiting Investment Banks**

The Volcker Rule is causing more jobs than those in foreign owned banks and their subsidiaries to leave the United States. A consequence of the proposed Volcker Rule is that prop traders are leaving the larger, more regulated banking entities to open new hedge funds in smaller, less regulated financial institutions that may or may not be in the United States. (Major Trends, 2011). Some of the exiting prop traders and hedge fund managers are moving offshore, often to Asia, and taking their talents and skills in creating wealth with them. Those who remain will have the added hurdle of competing with the offshore talent in international markets.

To understand the implications of the relocation of skills and talents to independent wealth managers, private asset managers, or insurance companies, the difference between a prop trader and hedge fund manager should be understood. While both prop traders and hedge fund managers are experienced with managing large amounts of capital, a bank prop trader has a different focus regarding capital and risk. Prop traders do not view capital as a tightly fixed amount (Analysis, 2011). They have an investment “credit line” financed through the bank’s balance sheet. By contrast, private asset managers and independent hedge fund managers are not a division in a larger entity with a larger balance sheet. Their capital is limited to the balance sheet of the assets they manage from day-to-day.

The second difference between prop trading and managing a hedge fund is the amount of cash maintained (Analysis). Prop traders can take more risk by working with minimal cash. Hedge fund managers maintain a certain amount of cash in preparation for customer redemptions. The higher percentage of cash balance reduces the amount of risk in the fund.

The third difference between prop trading and managing a hedge fund is diversification (Analysis). An individual prop trader can specialize in a single type of asset. Diversification is not a focus for an individual prop trader. It is established through the combination of the trading activities of the multiple prop traders in the banking entity who each specialize their area of asset classes. By contrast, a hedge fund manager is required to provide diversification within the fund. Diversification within a fund can decrease the amount of investible capital that can be used to manage risk while unwinding a position.

The differences between prop trading and hedge fund management lead to different risk management structures. The example set by MF Global Holdings, Ltd., which would not have been covered under the Volcker Rule, emphasizes the magnitude of the impact of the different risk management techniques that can result. Ultimately, the risk is transferred to the investor when losses are incurred from the failure of the smaller financial institution.
Following is a summary of events that led up to the filing for bankruptcy by MF Global. The summary provides insight into what can occur when risk is transferred by the Volcker Rule from large banking entities that build internal controls to disperse risk, to the more vulnerable segments of the financial system that do not have the capacity to control large amounts of risk.

Carney (2011) describes events that lead to MF Global’s filing for bankruptcy. After constructing what is traditionally viewed as a low risk “repo-to-maturity” trade of European debt with capital owned by the firm, the risk suddenly increased as the value of the bonds decreased. A circle of events resulted.

Regulators required more capital in preparation for probable margin calls, as well as the disclosure of the size of position. After learning the size of position and the higher risk due to the lower value of the bonds, ratings agencies issued downgrades of MF Global’s credit, which in turn led to further creditor calls for additional collateral.

**HEDGE FUNDS**

**Impact on Private Banking Wealth Management**

In his video produced by Kantola (2008), Jay Conger quoted a person he identified as a private banking executive for a large Swiss bank. The executive positioned the division’s attitude toward competition with the statement, “You are about to lose every second customer.” His words show how essential it is to compete to gain every new client that has an interest in investment and private banking, and to maintain a secure relationship with every one of the division’s established clients.

In response to the Volcker Rule, Private banking divisions may consider that statement to be more than a mere positioning of attitude. It may become reality, especially regarding their high net worth clients that provide a large percentage of a bank’s private investment capital. Rather than invest their wealth with private banking, they may move it to a private hedge fund, or they may open a family office. Families with $100 million or more have been increasingly trending toward opening independent offices. The lesser known method for managing wealth was first initiated when John D. Rockefeller’s family office was opened in 1882 to manage the family’s assets. With the introduction of the Volcker Rule, this lesser known method is becoming more widely implemented. A downside to the investor is that costs are increased with the smaller scale of the family office.

The opening of smaller scale and new hedge funds is transferring risk from more regulated entities to less regulated entities. The new hedge funds are not subject to the more rigorous regulations to which the covered financial entities must adhere. Consequently, investors are placing their wealth at a greater risk of loss in an environment that has less rigorous regulations.
Herding

To effectively manage or regulate systemic risk, it is essential to first understand the two channels through which the risk can occur, the direct channel and the indirect channel. King and Maier (2007) provide the following analysis of the two channels:

“A **direct channel** occurs when a collapse of a hedge fund (or group of hedge funds) holding large positions leads to forced liquidations of those positions at fire-sale prices. The impact on asset prices may be amplified through the use of leverage – whether created directly through the use of margin or indirectly through the embedded leverage of derivative positions. Such a disorderly unwinding, it is feared, could generate heavy losses to counterparties and ultimately contribute to severe financial distress at one or more systematically important financial institutions.

In the **indirect channel**, a forced hedge fund liquidation exacerbates market volatility and reduces liquidity in key markets. Systemic risk can occur when correlations in asset classes increase during times of stress, or when the potential for herding amplifies market movements.”

King and Maier (2007) caution that systemic risk increases when economies and markets experience increased stress. The correlation between asset classes increases, and hedge fund trades herd together - amplifying market movements. If a large enough number of hedge funds unknowingly herd together in a trade because it makes sense given market conditions, market volatility increases as does the potential for systemic risk with increased price movement. Tail risk events are occurring more frequently, again increasing the potential for systemic risk through herding.

The Volcker Rule does not address the potential for systemic risk from the domino effect of hedge funds and broker-dealers. As more independent hedge funds open due to the exit of traders and managers from the banking entities covered by the Volcker Rule, the phenomenon of herding should be taken into consideration. When herding occurs, the sum of the parts can add up to a systemically meaningful whole.

**Risk Transferred to the Vulnerable**

The Volcker Rule prohibiting banking entities from owning more than three percent in a hedge fund or private equity fund. One of the effects is to ultimately transfer the risk from the financial sector to vulnerable segments of the population, one of which is the current and future retirees through their dependence on pension funds.

There is a large dislocation in funding of pension funds that is driving the funds to increase investment in hedge funds to capture the absolute returns. In the White Paper, “Major Trends Occurring in 2011: Implications for Hedge Funds / Funds of Funds,” Infovest 21 (2011) writes about the increasing demand by pension funds that are underfunded. At year-end 2010, Standard & Poor’s estimated the amount of combined underfunding to be $315 billion for 1500 of the largest United States pension funds. In 2010, corporate pension funds were funded at average to 81 percent, and state and local funds were funded at
average to only 79 percent. Infovest21 further defined the lack of performance in pension funds that invested in the S&P 500, which had a return of only 0.4 percent during the ten years from 2000 to 2010.

With the Volcker Rule prohibiting prop trading and more than three percent ownership in hedge funds, the best and the brightest traders and managers are exiting the banks to manage hedge funds independently or within financial entities not covered by the rule. They will not be met with the regulatory concerns arising from the Volcker Rule, including limits on compensation (Major Trends, 2011). There are two issues that arise from the relocation of talent.

The first issue is that many of the skilled and talented prop traders do not have experience with running a business. The business activities that were segregated into separate departments of the bank suddenly become a part of the trader’s daily schedule when running a hedge fund outside of the banking entity (Major Trends). Higher costs are associated with the administrative duties of a hedge fund office. Commentary from a law firm in the “Major Trends Occurring in 2011” White Paper by Infovest21 provides perspective on the different requirements of a hedge fund that is managed outside of a banking entity. The law firm recommends:

“that managers adopt articulate FCPA (Foreign Corrupt Practices Act of 1977) compliance policies and procedures, establish oversight by senior executives with responsibility for compliance policy implementation and review, require annual certification and regular training, establish procedures for entering into a third party business relationship, create a reporting system to ensure that violations can be promptly detected and remedied, set up accounting procedures and controls to ensure accurate accounting and books and records, and have independent audits conducted.”

The broker-dealer MF Global provides an example of what can happen when accounting books and records are not accurate. Inaccurate accounting methods brought negotiations for a merger with other broker-dealers to a halt. MF Global was rapidly searching for a buyer with a larger balance sheet that could absorb the risk; however, each broker-dealer considering the merger stated they backed away after analyzing the books. The statement was made by one broker-dealer that it could not “get a good sense of what was on the balance sheet,” (Lucchetti & Patterson, 2011).

The only action remaining for MF Global was to file for bankruptcy. The events surrounding the filing support the statement made by Pirrong, a finance professor specializing in risk management at the University of Houston. Mehta (2011) quotes Pirrong; “You think you’re reducing risk but you’re shifting it around in ways that can come back and bite you. Customers will go to other financial entities. (The Volcker Rule) doesn’t make the problems go away. It just changes the location.” When herding is taken into consideration, Pirrong’s statement regarding the shifting of risk becomes even more deeply concerning.

At the time of the writing of this paper, $600 million of MF Global’s customer money cannot be found. In the article written by Lucchetti and Patterson (2011), a regulator with the Commodity Futures Trading
Commission (CFTC) stated that ten days out from the initial bankruptcy filing, the numbers are not leading the regulators to the customers’ money due to the condition of the accounting books.

Prior to the Volcker Rule, concern over customer money prompted some banking entities to construct a “fund of one,” (Major Trends, 2011). In response to the fraud from Madoff, private wealth divisions were increasing their due diligence teams and creating new products. The fund of one was a new product that was constructed with the investment from a single customer. The customer might be an individual, a pension fund, or another type of investor. A feature of the fund of one is that it eliminates the opportunity for the Ponzi scheme fraud committed by Madoff.

There are hurdles for smaller financial institutions that would consider offering the fund of one financial product. It can be cost prohibitive with the extra accounting, compliance and administration required, which makes it less attractive to hedge fund managers outside of investment banks. Another hurdle is the management of risk within the fund. Prop traders and fund managers are talented and skilled in their areas of specialization; however, their risk management skills were sharpened with a balance sheet that could absorb a greater amount of risk.

With its ties to Goldman Sachs talent, MF Global is an example of the difference in risk management techniques of a more constrained, broker-dealer balance sheet as compared to the larger investment bank balance sheet of Goldman Sachs. The relatively conservative risk management technique that matched the smaller MF Global balance sheet was ratcheted up by talent learned at the Goldman Sachs investment bank. A higher tolerance for risk had been learned while working with a much larger balance sheet (Brush, Harper & Moore, 2011). The trade that had been thought to involve low risk suddenly altered into a trade that involved too much risk for the smaller balance sheet of the broker-dealer. Where MF Global declared bankruptcy, Goldman Sachs more than likely would have had the capacity to manage the risk through additional hedging while unwinding the position.

Smaller banking entities with smaller balance sheets, as well as retirees, are more susceptible to risk. The Oregon public pension fund was invested in a fund that had been built to $7 billion and then used to invest in MF Global. The fund is down 60 percent (Erman, 2011).

When pension funds could invest in hedge funds managed by banks, they had the additional assurance of the bank performing due diligence to decrease the likelihood of fraud. With the prohibition in the Volcker Rule, pension funds along with all other investors in hedge funds, will have to rely on their independent due diligence while researching the fund manager’s competency and legitimacy. Competency and legitimacy are difficult to determine due to the trading strategies that are unique to hedge funds. The funds are not readily transparent. If one fund’s position and strategy is made known, another fund may take the opposite side, diminishing or eliminating the opportunity to make a return or potentially causing a loss.
Self-Imposed Reduction of Risk

The financial system has been actively working to reduce the amount of systemic risk since 2007. Tim Ryan, President and Chief Executive Officer of Securities Industry and Financial Markets Association (SIFMA) included the following quote in his opening remarks for the annual SIFMA meeting held November 7, 2011:

“Since the end of 2007, U.S. financial firms have raised more than $300 billion of common equity. The largest U.S. banks have reduced their average leverage ratio from 16:1 to 11:1 and increased loan loss reserves by about 200%. Off-balance sheet activity has also been reduced dramatically. Many have already undergone stress tests with both the Treasury and Fed. Over 90 percent of the TARP capital infusion funds into banks have already been repaid, with interest, dividend and warrant sales for a profit of $19 billion to the taxpayers to date.”

“At SIFMA, we have been focused from the very early days of regulatory reform on being productive participants in the process. Through our committees, on which almost 6,000 members from the industry participate, we provide information and analysis to help the regulators craft rules that work and create certainty. We support measures to restore faith and confidence in our financial system, such as establishing a systemic risk regulator and the designation of bank and non-bank firms as systemically important. We believe there should be a uniform fiduciary standard of care. We support risk retention and other improvements in the securitization space to help jumpstart recovery of the housing market. But we cannot support measures which disrupt market functions or increase systemic risk, ultimately failing to achieve what Congress and the Administration sought to accomplish with this legislation.”

Capitalism is strengthened by competition. If a business practice does not support the company’s sustainability, the company will take action to correct the practice. The financial industry is implementing the changed practices as noted in Tim Ryan’s statement to decrease systemic risk. This will increase the sustainability of banking entities and of the financial system.

CONCLUSION

Intended results of the proposed Volcker Rule are to reduce risk of lost investor deposits and to reduce systemic risk in the financial system. However, the magnitude of the impact caused by the unintended consequences may derail the intended results.

In its current form, the proposed rule lacks clarity between prohibited proprietary trading and allowed market making activities. As covered banking entities end prop trading, they may also decrease market making due to a lack of clear definition. The result will be less liquidity in the markets, a larger bid ask price spread, and less market efficiency. All of these consequences of the proposed Volcker Rule will increase costs for investors.
Further effects of the proposed Volcker Rule are to lose jobs in the United States and to decrease revenue while also significantly increasing costs of compliance for banks. These events are occurring at a time when the banking entities are recovering from the recent financial crisis, and when economic recovery has been slow.

The increase in required bureaucracy and the high costs associated with compliance with the Volcker Rule have the potential to cause foreign banks to cease conducting business within the United States and to avoid working with United States customers. Either the revenues generated from the transactions will not cover the costs and the associated bureaucracy, or the United States customer will pay substantially higher costs for the financial service. If enforced, the proposed rule will place United States banks as well as United States companies at a disadvantage while competing in the global markets.

Investment by banking entities covered by the proposed Volcker Rule in hedge funds and private equity funds is limited to 3 percent. Risk is transferring from regulated banking entities to less regulated asset managers and insurance companies. Prop traders are exiting investment banks to open new hedge funds, and banking entities are exiting their prohibited ownership or relationships with hedge funds.

Pension funds that are underfunded are increasing their search for absolute returns generated by hedge funds and returns from private equity funds. The unintended consequence of reducing systemic risk in banking entities will be the transfer of risk to relatively unregulated financial asset management entities and the vulnerable current and future retirees through underfunded pension funds.

In divergence from the Volcker Rule, rather than prohibit prop trading, banks should be regulated to limit prop trading to tier three capital. Two objectives would be met with the implementation of this type of regulation. Customer deposits would be protected from prop trading activities, and banks would not be unduly concerned about how the regulatory agencies would interpret their market making activities. Banks would self-regulate tier three capital prop trading to protect dividend payouts to their investors. Market liquidity would not be negatively impacted by regulation. Investors would benefit through a more competitive investment environment that would maintain market liquidity and lower costs.

Rather than severely limit regulated banking entity ownership or relationships with hedge funds and private equity funds, systemic risk can be reduced by lowering the amount of leverage allowed to generate the absolute return. The future and current retirees depending on pension funds will benefit from the increased competition between banking entities with larger balance sheets within an investment environment that is more carefully regulated.
APPENDIX A
Citations

Analysis: Differences Between the Hedge Fund Manager and the Prop Trader. (2011, Feb 14).


