Volcker Revision: A Toxic Proposal

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The FED, SEC, CFTC, OCC, and FDIC (collectively, the "Agencies") are rounding out public comments on their proposed revision to the Dodd-Frank Volcker Rule. The agencies' proposal is like "putting the cart before the horse" to retrofit banks' flawed risk management frameworks as a Volcker revision, because such a "risk approach" was proven ineffective during the last financial crisis.

The proposal will reverse years of effort by Troubled Asset Relief Program to "separate out the bad banks." What's more, it will allow toxicity to reenter the banking system, benefiting only "junk" merchants that have little or no skin in the game.

The table below highlights some loopholes hidden in the details of the proposed revision of the Volcker Rule:

"Subterfuge" of the Agencies' proposal	Implications
Accounting prong + trading account/ desk redefinitions	Wide open backdoors (especially Subpart B §_.3(d) liquidity management exclusion) to proprietary trading
Reliance on internal set limit (Subpart B §_.4(b), (e)). Eliminate the need for a definition for "market-maker inventory". No longer require banks to conduct a demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and other factors regarding the amount, types, and risks of or associated with positions in financial instruments (remove purpose test/ short-term prong).	Downplay risk of unreasonable activities amid cases of blindsided risky positions and dodged regulatory oversight. Trade under the guise of market-making exclusion even it would not fit the SEC's market-making definition per se. Indirectly weaken stance against "conflict of interest" (Subpart B §_.7(a)) when controls may be bypassed through transfers in-and-out of category between available-for-sale and hold-till-maturity and/or a flipping-switch between dealing with "client" versus "counterparty".
Sub-B §_.3(c) Presumption of compliance	Eliminate problem by turning a blind eye to it → no demonstration of how exclusions are qualified, which affects §_.4(c), (d), (f), (g)
Reservation of authority on high-risk assets and high-risk trading strategies	Trim almost everything, the residual "High-Risk Asset" and "High-Risk Trading Strategy" (Subpart B §_.7(b) Backstop provision) is hard to enforce
Carve-out ASC-815 derivatives + no correlation analysis + demonstrably reduce (or otherwise significantly mitigate) risk be removed	Invite gaming of control (§_.4(h) and §_.5(b)), use of instruments and inventory level are unaccounted for, risks not "specified" → bets and abuses to cover/ hide losses, violate Fed Reg. 5542
Remove §_.20(c) Appendix B + replace ownership test with vague fund characteristics, carve-out non-traditional structured Hedge Funds / Private Equities	Allow toxic to retain and reflate at banks, circumvent sponsor limit, opposite the President's "America First" principles
Cost-benefit justifications	It is the deposit insurance mechanism ($2 billion/ year + cost to bring banks into conformance with FDIC) that out-weighted its benefits ($73.1 to "move" every $100 for resolution disbursements in the past 5 years), not Volcker.

According to the 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." This filled a vital money gap where the U.S. faced massive sell-off of treasuries from foreign creditors (see this).

Volcker's favorable policy has made the U.S. government debt less dependent on foreign countries, such as China. Tragically, the agencies' top officials overlooked the Rule synchronization with President Trump's "America First" principle. Consequently, the agencies' proposal would inadvertently push banks to abandon prudent investment in U.S. Treasury and other U.S. agencies securities.

As a result, if banks recklessly pursuit higher (unsustainable) yields in risky and illiquid products, it will cause an "irrational exuberance." The timing could not be more disastrous, amid the largest budget deficit in the U.S. history and a flattened (possible inversion) of the yield curve!

Practical Advice for Moving Forward

To avoid a 2008-like crisis, the agencies should perform a holistic review of the outdated deposit insurance mechanism, because it is unfit for the 21st century challenges (flash crashes, too-big-to-fail, and financial engineering abuses in particular). Unfortunately, the FED is proposing to relax the capital rule in parallel with Volcker revision. Hence, there won't be adequate capital to address the shortcomings of deposit insurance (moral hazard, in particular).

If implemented properly, the Volcker Rule would not only fill this policy gap but also address the too-big-to-fail issue. We advocate for using innovative RiskTech and BPO to:

- Gauge "reasonableness" in securities inventory each day via an empirical RENTD calculator;
- Distinguish permissible versus prohibited activities, and prevent bypassing of controls via automated surveillance; and
- Monitor the banking entity's investments in, and transactions with, any covered funds.

The current and proposed metrics are not effective to deal with rapidly evolving issues proliferated by hidden problems and silos. If trade activities can consistently be scrutinized per our suggestions, then the Agencies may publicize the percentage of suspicious trades being "red-flagged" to enhance transparency of the Rule's implementation. This would essentially eliminate all metric requirements, but the agencies could ask for, or commission, a "comprehensive profit and loss attribution study"* when symptoms of control weakness are identified by the surveillance system.

Moreover, we see an opportunity to streamline the Rule's covered fund provision by rewritten it to become the 21st Century Glass-Steagall Act, which prohibited banks from participating in hedge funds, private equity funds and other (similar) businesses. To ensure shifted risks won't come back to haunt banks, one should consider the use behavioral science to ensure "exit only, no re-entry" deals – like "letting go" of bad habits or toxic assets.

Finally, the Volcker Rule's preventive approach is better than salvaging a troubled bank through other regulatory measures. This is because "demonstrating compliance" can help restore a healthy hierarchy of diversified banks, so that tier-two banks would be ready to step-up whenever a failed global systemically important bank is under stress.

Streamlining the right priorities, to save costs and foster control improvements, should be the bottom line in achieving the Rule's financial stability goals. I'm afraid, however, that these goals are not met by the agencies' existing proposal.

Please see here the full comments that I have submitted to the agencies.