Volcker Rule: Proposed Revisions vs. Potential Reality

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

The likely Volcker revisions have been so well articulated that they have "almost felt like hope" when it comes to advancing risk practices. Supervisory agencies and the industry seem to be in harmony on many of the proposed changes – debunking their elusive plot now is like being a party pooper, but the Rule has essentially ceased to exist except in name. So, let's predict what will happen.

Prediction 1: Don't believe the hype

Imagine an upbeat speech by President Trump describing how holistic, innovative, and cost effective the new Volcker Rule revision will be, followed by Treasury Secretary Mnuchin or Acting OCC Comptroller Noreika elaborating on the benefits of ERM, CRB, risk data aggregation, advanced risk models, central monitoring, etc.

By adding fluff and buzzwords borrowed from a number of supervisory objectives and risk concepts, risk management becomes the most promising Volcker Rule hype to distract you from scrutinizing whether banks genuinely trade on behalf of customers, or engage in proprietary bets to speculate in the markets. There are important differences between the two activities. Bank customers could suffer from inherent conflict of interest (see this empirical research by Steven and Steven). It'll be imprudent not to curb abusive and exploitation behaviors of banks.

Although huge proprietary trading loss may not necessarily trigger an emergency bail out of a bank using taxpayer money, a billion dollar trading loss could trigger systemic failure, like the downfall of Barings and other crises (see this). In the case of 2012 JPMorgan Chase (JPMC) trading loss, it was more than $6 billion. The purpose of the Volcker Rule is aimed exactly at addressing flaws in this JPMC case (i.e. "mischaracterized high risk trading as hedging, hid massive losses, disregarded risk, dodged OCC oversight" – see 2013 Senate report for details). Industry experts have predicted an increase of such risk events might be coming. Given that flash crashes could be fueled by banks instead of high frequency trading firms (see this/ FCA findings), brace yourself for market disruptions.

Prediction 2: Reasonably irresponsible

Following the 2012 JPMC case, there was a Bank of America (BoA) case in which risk limits were set too high and the bank allegedly triggered 15 occasions of mini-crashes in the market between late 2012 to mid-2014. How would that be "reasonable" if under the Volcker regime?! Sadly, after the Volcker Rule came into effect in 2015, there's the Credit Suisse (CS) case emerged in which the CEO was "blindsided" about bank's added risky positions. CS incurred more than a billion-dollar trading loss in 2016.

Despite the fact that RENT-D/ inventory concept was mentioned 581 times in the final rule to emphasize its importance, the industry hasn't been serious about what's "reasonable." In April 2017, Deutsche became the first ever bank to receive a fine of $19.71 million for allegedly violating the Volcker Rule. In particular, the Fed's enforcement order said the bank "did not subject trading desks' RENT-D methodologies to sufficient review or challenge by internal control groups."

In my opinion, though, regulators are majoring in the minors to pin-point the "formality" of how risk appetite is set. They forgot that some of the biggest threats are the result of many small incremental exploitations or hedges and/or commitments – each accumulate into outsized bets or bubbles. These toxic positions can be so tangled-up that banks do not want to hold risky assets because of higher capital surcharge. But, a fire sale could cause major losses for the bank, or potential crashes, similar to what happened in the BoA case. It's a dilemma for trading desks to determine optimal strategy and market timing for their protective hedges. The FCA findings have exposed the ugly truth about how quick banks withdrew liquidity at the time of the crash. In short, RENT-D must consider the dynamic of market microstructure and be calculated at least daily.

Prediction 3: Catch me if you can

RENT-D is about the right amount of trades at the right time, whereas outsized bets might be synthetically created. The rogue trader in 2008 Société Générale (SG) case was being slick to cancel fictitious or suspicious trades whenever he was challenged by control department. He would replace the bet using a different instrument, or a series of combo-trades, to bypass scrutiny. Unauthorized trades were totaling as much as $72 billion.

The matter isn't so much about risk culture or a bank's governance control (e.g., SG failed despite Daniel Bouton's pride in the bank's internal control strengths). Rather, it's all about "agility" of risk management practices and "timeliness" to act upon warning signals.

Sadly, policy-makers did not take heed of the lesson. They accepted the lobbyists' proposal to eliminate a transaction-by-transaction approach to trade surveillance, and transparency actually decreased. That little footnote 711 on 79 FR 5592 has killed the opportunity to address the 21st century's biggest financial threat: abusive use of financial engineering techniques.

It'll be worse if the rebuttable presumption ("guilty until proven otherwise") clause is repealed. Banks will no longer be required to "demonstrate" compliance. Good luck identifying irregularities and catching rogue alchemists through the use of flawed metric report (remember: JPMC which invented the most widely used Value-at-Risk metric, also failed in 2012).

Prediction 4: Covered funds will prove problematic

Many organizations have place the Rule's covered fund requirements on the backburner, because banks would seemingly have until 2022 to comply with this requirement under the Federal Reserve's extension. The reality, however, is that the 2022 deadline was intended for a stable run-off of illiquid funds that only existed prior to 2014.

Bloomberg created a covered fund identifier (CFID) product that uses CUSIP as its sole searching criteria. But the existing definition of covered funds and related exemptions (under Volcker) are extremely broad and comprehensive. Thus, the effectiveness of Bloomberg's CUSIP matching tool was challenged by the Fed's FAQ#17 and this SIA briefing note.

What's more, foreign covered funds and other private investment vehicles do not have standardized CUSIPs. The job of meeting the Rule's requirements for covered funds will be a huge undertaking, requiring banks to manually go through the countless offering documents to determine their permissibility. Indeed, this is a bigger burden on banks than complying with the proprietary trading ban provision.

Interestingly, the Fed recently issued a No Action Relief (until July 2018) on certain "qualifying foreign excluded funds." It is becoming obvious who is going to benefit the most if the covered funds' definition is drastically narrowed to just hedge funds (HFs) and private equity funds (PEFs) with CUSIPs.

Prediction 5: Cooking the books

Instead of separating the commercial and investment banking, *a la* the Glass-Steagall Act in 1930s, a split between banks and HFs/PEs has already been made. It shifts much of the proprietary trading risk away from the banking system. Many ex-bankers indeed join or start their own HFs/PEs, which surprisingly have a positive effect on the market with more diversified players. Though some bank alumnus at HFs/PEs do receive sponsorship money from their old employers, but that implicit control by banks is through an arm's length.

However, if the 3% limit on banks' sponsorship of HFs and PEs is lifted or significantly increased, and if affiliated transactions are more tolerant than the existing Super 23A/23B requirements, then books might get easier to cook!!