☏ 617.237.6111
✉info@databoiler.com
DataBoiler.com

Volcker Rule: Legitimate Liquidity Concerns or Irrational Market Fears?

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

Even as the deadline (July 21) for compliance recently passed, many banks remain critical of the Volcker Rule, claiming that it kills market liquidity. But is the proprietary trading ban really problematic, or is this reminiscent of the so-called "dihydrogen monoxide" prank?

This social experiment (click here for more info) entails asking people to sign a petition to ban water by calling it by its unfamiliar chemical name (dihydrogen monoxide) and by listing some of its potentially "dangerous" effects in an alarming manner. It illustrates how a lack of scientific literacy and an exaggerated analysis can lead to misplaced fears.

The Volcker Rule, one could argue, is plagued by a similar lack of scientific data and unfounded fears. This whitepaper uses various market observations to review whether the rule will have ripple effects on liquidity, partly because the industry has misplaced fears or misunderstandings about it. We also explore whether there is any substance behind the risk control and financial stability improvements the rule is expected to yield.

Let's now discuss some observations about the industry's level of preparedness for the Volcker Rule:

1. Many banks already claim to be in compliance with the rule, noting that they have either never engaged in proprietary trading or that their proprietary trading desks have already been shut down.

   Neither of these claims would satisfy regulatory requirements. Shutting down your proprietary trading desk *does not* mean that you're already qualified for exemptions from the rule. Basically, the rule states that banks are "guilty until proven otherwise." Regardless of whether you have a proprietary trading desk, all trades must be subjected to rigorous testing in order to "qualify" for the necessary exemptions.

   Don't forget that rogue traders can use other desks to game the system, if there is no proper control in place. Reducing market activities is a logical consequence if other players (entities not covered under Volcker) aren't assuming a bigger role.

2. Banks have both tightened risk limits and implemented comprehensive policy frameworks and procedures.

☏ 617.237.6111
✉info@databoiler.com
DataBoiler.com

Policy frameworks and procedures are all good, as long as they can be enforced. It is humanly impossible to monitor millions of trades manually, in real-time, where losses can be accumulated in a split second. If your controls aren't quarantining prohibited trades in real-time, then you *do not* have a "preventive" risk management system (see Spam Filtering the Prohibited).

Tactics that tighten your firm's trade appetite are *not* a substitute to the requirement of having a "preventive system." At the end of the day, you need to ask whether your firm's CEO and CCO would sign off on the controls and measures you have in place.

3. Some banks remain in denial, arguing that they are not G-SIBs, and are therefore not subject to the Volcker Rule, because they have only limited trade activities that do not involve market making.

Though smaller banks may neither have market making nor underwriting, they still have a treasury desk (for liquidity management) and still perform risk-mitigating hedges. While acknowledging the unfairness of subjecting community banks to the same rule as G-SIBs, we must point out that regulators are like overprotective parents who are concerned that their rules/controls might be bypassed (see Volcker's Intent is Hacked and Leaked). Tier 2 and smaller banks therefore need help to bear the cost of improving risk controls.

Building a risk and compliance utility model allows costs to be minimized and shared by participant banks. The running cost of this shared system could potentially be funded, at least partially, by charging a small toll for trades that have been successfully quarantined. Moreover, banks that qualify for the appropriate exemptions can minimize costs.

In short, the Volcker Rule represents an opportunity for Tier 2 and smaller banks to step up their game in sales and trading, as well as to improve their risk management capabilities. The point is that these banks either need to go big (with improved risk management capabilities) or go insignificant (i.e., to cut their assets below $10 billion).

4. Banks are using a "risk-based" approach for RENTD, limiting their securities inventory to no more than 60 days.

☏ 617.237.6111
✉info@databoiler.com
DataBoiler.com

A "risk-based" approach to Volcker inventory has been advocated in the past, particularly in footnotes section (#1512 and #1513) of 79 Fed Reg. 5654. Indeed, a number of commenters in that publication objected to a transaction-based approach to the rule, arguing that it would cut off U.S. financial markets from foreign capital and result in U.S. financial markets moving offshore.

In response, the final Volcker Rule adopts the SOTUS exemptions for foreign banking entities. That statute, however, does not make this risk-based approach exemption available to U.S. banking entities or to their foreign subsidiaries and affiliates. (See pages 15 and 16 of this Federal Reserve memo for reference).

What's more, 79 Fed Reg. 5592 shouldn't be inappropriately interpreted as backing the argument to support U.S. banking entities to use "risk-based" approach, because it refers (in Footnote #716) to "principal" exposure as inventory, rather than as "risk" exposure. This is a red flag that regulators may use to nab anyone who is 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 parameters under their so called "risk-based" approach), they can potentially (through the use of multiple instruments) create synthetic trades that would otherwise be prohibited.

Another seemingly false teaching is the "60 days haircut" approach to inventory. Although "60 days" is usually used as a benchmark for near-term transactions, regulators never rule out inventory over 60 days.

Just like there are bound to be people with large feet who need size 18 shoes, we have to cater for outliers, no matter how small the percentage may be. Fortunately, there are formulas that we can use to justify those infrequent trade instruments for the securities inventory plan.

Traders are, in fact, looking for incentives to carry long-dated inventories – and they therefore expect related trading costs to rise.

5. Banks are now recalibrating risk models quarterly, and Reasonable Expected Near-Term Demand (RENTD) is now being jointly set (quarterly) by risk and trading teams.

Firms that regularly review and recalibrate risk mitigating hedges should be applauded for their good practices.

☏ 617.237.6111
✉info@databoiler.com
DataBoiler.com

Everyone knows the markets are dynamically changing every single day, if not faster. Remember, exposures can accumulate quickly if prohibited trades are artificially claimed as risk mitigating hedges. Therefore, all preventive measures have to be done on a trade-by-trade basis (per §_5(b) of the final Volcker Rule); otherwise, you'll leave an opening for rogue traders to game the controls.

The RENTD/security inventory plan should also be executed dynamically, on a trade-by-trade basis. Using static "governance documents" to state what is/is not allowed (from a trading perspective) is not considered a "forecast." RENTD/ securities inventory plan forecasting and reforecasting should reflect who the banks are and should demonstrate: (1) how their trading desks respond to market changes; (2) changes in clients' appetite; (3) instruments' payoff; and (4) risk convexity changes.

It should go beyond a generic trade appetite of doing "X" millions of trades in Y instrument every week under a normal market condition. It should also include a RENTD stress trigger; ongoing monitoring of event-driven factors; rationales to justify any deterministic factors; and analytics-based historical data.

Think about it: nobody want the regulators to use one "generic" template to measure the effectiveness of a bank's RENTD/ security inventory plan in comparison to similar banks. Therefore, this is your opportunity to show the regulators the unique differences in the nature of your trading desk, as well as your trading specialties in certain markets and/or instruments. Moreover, you can also substantiate why your trade appetite is "reasonable."

6. Banks have devoted a lot of resources to preparing metrics for regulators.

Of course, it is difficult to do metric reports on a global scale. It is even harder when they involve manual regurgitation from multiple data sources. Indeed, this is backward - because reports are supposed to be the end-product of a robust system. With regards to building a robust system for Volcker compliance, the issue is really about RENTD, rather than metric reports.

The Office of Comptroller of Currency's analysis of 12 CFR Part 44 (click here and see table 2 for details) indicates that banks' estimated annual compliance expenditures associated with the final Volcker Rule range from $402 million to $526 million.

☏ 617.237.6111
✉info@databoiler.com
DataBoiler.com

One thing is clear: the money allocated to Volcker Rule compliance must be spent wisely. If efforts are not sufficiently channeled into determining RENTD – or, in other words, the "reasonableness" of banks' trading activities – firms will be more reluctant in the future to execute trades. The "fewer trades, fewer chances of errors" mentality is simply the wrong approach toward Volcker compliance.

Parting Thoughts

Concerns about liquidity becoming fragmented or dried up as a result of the Volcker Rule are unfounded. As in the "dihydrogen monoxide" hoax, panic and fear can paralyze the ability of people to think and act wisely.

Instead of giving in to fear or listening to false teachings, try your best to understand the unfamiliar concepts of "securities inventory" and the true meaning of Volcker compliance. Only then will you comprehend the true benefits (e.g., enhanced risk controls) of the rule.

Ultimately, the Volcker Rule should 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 is the founder and president of Data Boiler Technologies.

He has more than 20 years of experience in strategic planning and corporate development, with a strong emphasis on Business Modeling and LEAN Six Sigma. Prior to his current role, he served as a vice president for Broadridge; a functional head for Citigroup; a subject matter expert in corporate finance for the Institute of Bankers; and a lecturer for various professional organizations. While at Citigroup, he formulated a 500+% growth model by leveraging Big Data analytics.