

What is the Volcker Rule?

by Wallace Turbeville

The Volcker Rule is a requirement in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 that is sometimes referred to as a “mini-Glass-Steagall.” It is based on the same principle that kept banking safe between the Depression-era bank reforms and the Clinton-era deregulation, which included the repeal of Glass-Steagall: because of their importance to the credit system and the real economy, banks that take deposits (which are insured by the FDIC) should not take on certain risks inherent in the securities and derivatives markets.

Once commercial banks were allowed in the late 1990s to merge with investment banks, own hedge funds and speculate in the markets with depositors’ funds, they became much more likely to fail. The Volcker Rule does not require the new combined banks to separate, but it does restore the idea that depository banks’ core function should be lending and facilitating trades for its customers, not taking on market price exposures that put banks at risk.

The Volcker Rule accomplishes this by prohibiting banks from taking “proprietary” bets for their own profit, with taxpayer-backed deposit funds, and limiting banks’ investments in private leveraged investment funds. Experts studying pre-2008 bank activity found that proprietary trading and hedge and private equity fund speculation introduced needless volatility into the core credit markets, put banks in conflict with their clients, and diverted bank capital away from loans to America’s small businesses and families. The Volcker Rule also bans firms from packaging risky securities for customers and then betting that they will fail, a practice at the center of the 2010 Goldman Sachs SEC fraud case.

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What Exactly Is Proprietary Trading?

Proprietary trading is defined in the Rule as taking positions in securities or derivatives for the purpose of realizing profits from short-term price moves. The Rule’s definition relies heavily on the concept of “trading

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accounts,” used already in the market risk capital rules applicable to banks, generally providing that positions held in trading accounts are held for the prohibited purpose. Banks should have no difficulty discerning what constitutes proprietary trading.

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Can Banks Still Operate Hedge Funds?

During the final days of Dodd-Frank debate, Senator Scott Brown (R-MA) was able to win an exception in the Volcker Rule's original private fund ban to allow banks to continue to own these funds, and invest up to 3% of their capital in them in the aggregate (and no more than 3% in any given fund). However, banks have to set aside in capital reserves amounts equal to their investment in these funds and are prohibited from bailing them out, as banks did during the 2008 crisis.

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What is the Cost of Proprietary Trading?

Proprietary trading can be immensely profitable to banks that have access to low cost deposits as a funding source, if they are allowed to put these funds at risk. This incentivizes trading activity far in excess of what is needed to provide for the intermediation of available investment money and its productive uses, such as funding productive assets, innovation, infrastructure, and credit needed by households. It has been referred to as a major source of the increasing “financialization” of the economy. The profits earned from financialization flow to the

financial sector and burden the more productive sectors. This excess value extracted by the financial sector has been estimated to exceed \$685 billion per year, and a large portion of this is derived from proprietary trading.

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Will the Volcker Rule Really End “Too Big to Fail”?

There are three ways to address the problem of “Too Big to Fail.” The first is to diminish the probability of bank failure by instituting safeguards against excessive risk such as the Volcker Rule; it addresses the problem of “Too Likely to Fail.” The second approach is to ensure that if, nevertheless, a financial institution faces massive losses, it can—as with non-financial firms—be put out of business in an orderly way without endangering the rest of the market or the broader economy. The Dodd-Frank Act's Title II attempts this with a new Resolution Authority to allow all financial firms to go through a bankruptcy-like process. Nevertheless, the new process has yet to be tested and some commentators are doubtful about the ability of complex, international megabanks to be easily resolved. The third way to ensure that no bank is too big to fail is to limit banks' size and scope of activities so that any one bank's failure will have a limited impact. Congress has failed to pass reforms like Brown-Kaufman SAFE Banking Act in 2009 or this year's 21st Century Glass-Steagall Act, but a little-noticed provision in Dodd-Frank does give the Systemic Risk Council of regulators the authority to break up a bank it considers “a grave threat to the economy.”

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Are the Volcker Rule Proposed Regulations Really as Long and Complex as People Have Said?

The proposed rules are somewhat complex, but by no means remarkably so for financial regulations. Importantly, almost all of the complexity has to do with the exceptions from the general prohibitions that were included at the insistence of the banks.

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What are the Exclusions from the Volcker Rule?

The Rule establishes a series of exclusions from the proprietary trading ban. Several are based on asset class assumed to be less risky, such as US treasury obligations and municipal bonds. The others relate to bank activities to maintain liquidity, such as repurchase agreements (“repos”) and securities and derivatives specifically held to maintain liquidity. The need for these liquidity exclusions is questionable: if the positions are held for liquidity purposes they are not held to profit from short-term price swings. Therefore, they do not constitute proprietary trading and need not be specifically excluded. Presumably, the regulators sought to provide certainty to the banks, but the exclusions are likely invitations to game the rules.

Certain types of asset-backed securities vehicles fall within the Investment Company Act rules used to define the scope of hedge and private equity funds. The Dodd-Frank Act provision expresses an intent to preserve activity in the asset-backed securi-

ties market, so pools of mortgages or other loans that fall under the definition are excluded.

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What Activities Are Excepted From The Proprietary Trading Ban?

The statute and the proposed rules carve out specific exceptions and the two most controversial ones are for “market making” and “hedging.” It should be noted that the precondition is that the market making and hedging activity is proprietary trading in the first instance. Then the exception kicks in.

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What Is Market Making?

Traditionally, markets are venues in which buyers and sellers are matched and transactions executed based on agreed terms, such as product (e.g., common shares of Apple), price, and quantity. The market participants typically can see offers to buy at one price and offers to sell at another. (If there is an offer to buy and an offer to sell at the same price, there is a match and the trade is consummated.) The buy price is the “bid” and the sell price is the “ask.”

A market maker is a financial entity that simultaneously posts both bid and ask prices, intending to profit from the spread between the two. For instance, it will often buy from an investor at the bid price and sell immediately at the ask price. Market makers typically hold inventories to support the business by assuring continuous flow. Thus if the market maker sells shares from its inventory, it may well cover the sale by buying shares on the market and replenishing its in-

ventory. It is a low-risk, low-profit business that provides reliable access to the market for investment bank customers.

The market making exception to the Volcker Rule raises some difficult issues. The traditional market making activity can be manipulated so that a bank is actually profiting (and risking a loss) from price swings for its own account, as opposed to facilitating trades for customers. For example, a bank could quote a bid or ask price that is well off the market. It could establish positions and not close them out promptly for the spread. And, perhaps of the greatest concern, the purported market maker could maintain substantially higher inventory than is sensible for the business flow. These manipulations of the definition have become commonplace on Wall Street. Detecting such a manipulation requires methods of monitoring the individual areas of market making in a bank.

There is one other major issue with Volcker Rule exceptions. Many derivative contracts do not have an associated traditional marketplace. There are no continuously quoted bid and ask prices. Therefore, if a bank transacts such a derivative with a customer who wants the position, there is no objectively discernable price at which the bank can close out the position. The question then arises whether such an activity is market making or simply taking on a risk position.

Many who favor more prudent rules have observed that Congress excepted market making because it was relatively less risky. They have argued for a more restricted reading of the term. In reformers' view, the test should be whether the bank can reasonably assess the financial outcome of the market making transaction

based on objective information, that is to say actual contemporaneous transactions that provide price data for reversing the position.

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Do The Proposed Rules Impose Burdensome Requirements On Legitimate Market Making?

The proposed rules require banks to adopt and comply with written operational guidelines that define their market making businesses consistently with the rules. They also require compensation guidelines that are consistent with the low-profit, low-risk business of market making, not with the high-gain, high-risk business of proprietary trading. One of the requirements to which banks have objected is the provision that banks run and report specific calculations designed to set off alarms if the revenues or inventory levels from a purported market making business are inconsistent with market making. The complaint that these calculations are burdensome is not persuasive. If a bank has designated a desk (or group of traders) to engage in market making for a given class of securities or derivatives, the bank should monitor the activity of the desk to make certain that it is not exceeding its mandate. In other words, the bank should be running the revenue and inventory calculations required under the proposed rules to protect itself. It is probable that almost all banks do monitor their desks this way and are simply complaining in an attempt to avoid the risk that they might be held accountable to regulators at some later date. But if they are not running these analytics, they should be.

What Is The Hedging Exemption?

The Dodd-Frank act specifies that risk-reducing hedges should be allowed. The question is: what is risk reducing?

Every position involves the risk of a price change. Sometimes this is straight-forward and sometimes it is not. For instance, holding 100 shares of Acme, Inc. that is currently trading at \$50/share exposes a bank to the risk that the price goes to \$40. But if one holds an option to purchase Apple shares at \$45 when the price is at \$50, there is risk that the price drops to \$45, but no risk of the price dropping further.¹ The risks of the two positions have common characteristics, but they are not the same.

The controversy concerns imperfect hedging, or a position that diminishes risk but has further implications. Those who are proponents of more prudent regulations have argued for “congruency.” The Volcker Rule appears to adopt this approach. Here is an example that explains the concept in the context of the natural gas market:

The gas market is based on pipeline hubs from which natural gas is transported in spokes. The primary natural gas hub is called the Henry Hub. The price of gas at the Henry Hub is widely known. The price at the end of a spoke from the Henry Hub, say a delivery point in Houston, is equal to the Henry Hub price plus the cost of transmission to the point of delivery.

Assume the bank has a position that exposes it to natural gas

price increases in Houston. This of course must fall into some exception from the proprietary trading ban to be permissible. The risk can be thought of as the risk of a rise in the Henry Hub Price (“Negative HH”) plus the risk of a rise in transmission cost to Houston (“Negative Houston Transmission”). If the bank puts on a position that benefits from a price rise at Henry Hub (“Positive HH”), a portion of the risk of the original position that exposes the bank to price rises at Houston is offset. This can be depicted as follows:

$$\text{(Negative HH + Negative Houston Transmission) + (Positive HH) = Negative Houston Transmission}$$

This is a straightforwardly risk-reducing hedge. The remainder risk, Negative Houston Transmission, was held by the bank before the offsetting Positive HH position, the hedge, was entered into. The original risk (that qualified under some exception to the proprietary trading ban) was reduced, albeit incompletely. And no risk was added.

But assume that the bank held a position that benefitted from a rise in Henry Hub prices (and therefore exposed the bank to the risk of a fall in prices at Henry Hub). Would a purported hedge using a Houston position that exposed the bank to the risk

of rising prices in Houston be permitted as a hedge? It would work this way:

$$\begin{aligned} &(\text{Positive HH}) + (\text{Negative HH} + \\ &\text{Negative Houston Transmission}) \\ &= \text{Negative Houston Transmission} \end{aligned}$$

In this case the remainder risk was not an element of the initial position. It constitutes an entirely new position in Houston transmission costs and this position has no Volcker Rule exception to rely on, such as market making.

Congruity means that the new position must not expose the bank to risks that were not in the original position. The proposed rules require this, but there is much push back from the banks. The outcome is tremendously important. The example above is very simple, but the relationships between derivatives can be extraordinarily complex. The business activity that the banks describe as hedging is wildly complicated and the risks that are generated from “hedging” are particularly problematic because they are arcane and virtually impossible to value.

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What Is Portfolio Hedging?

The statutory language says that hedges must reduce the risk of contracts, holdings or positions. Many banks have engaged in trading that they describe as “portfolio hedging”: hedging risks that they have not yet taken. They claim that they are hedging in a general sense based on risks they may

be exposed to in the future. The JP Morgan Chase “London Whale” claimed to be portfolio hedging when he lost over \$6 billion in trades. The proposed rules indicate that the risks to be hedged must be specific and identified, but the language is unclear. This is why JP Morgan Chase lobbyists initially took the position that the London Whale proprietary trades would have been permitted under the Volcker Rule. ●

Endnotes

1. This is an over simplification. Even if the price is below \$45, the option has some value because there is some probability that the price will rally above \$45 before the option contract expires. This is commonly referred to as the option value and it is very different from the price of the underlying security. Even below the option price, there is risk of further deterioration of the option value as the underlying price falls further away from the option exercise price and the time left to recover from the price drop diminishes.

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