The Volcker Rule: Addressing Systemic Risk

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Evaluating the Volcker Rule

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Americans for Financial Reform

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Focus on Issues of The Need for Broad Monitoring and Enforcement of the Volcker Rule to Protect Financial Stability

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My Main Arguments:

- **Prop trading played a big role in the current financial crisis:**
  - It contributed significantly to the sustaining the housing and credit bubbles
  - It contributed significantly to the balance sheet and income problems of major investment banks
- **Prop trading contributed a substantial amount in terms of both profits**

- **Exempted activities, such as "market making" must be scrutinized carefully for their potential**
- **negative impacts on financial stability.**

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Pundits Say Prop trading did not crash the system

But played big role

- **helped prolong the bubble**
- **intertwined big banks with complex networks of debts and bets**
- **basis for shorting the system and creating incentives to keep it going**

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Financial Institutions held substantial toxic assets

For example, by mid-April 2008 large banks had lost roughly $230 billion on their super-senior proprietary holdings, which regulators thought were simply inventories to facilitate client trading. (Tett, FT, 2008)

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These data suggest:

Major banks were holding $3/4 trillion dollars of these highly risky assets.

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Large holdings of Prop Assets helped fuel credit and housing bubble.

-- By running large trading books, banks had inside information on client trades which they could use to front run in their prop trades, sustaining upward pressure on security prices

--Banks borrowed enormous amounts of short term funds – mostly repos – to finance trading book, taking on leverage and making them susceptible to runs by the financial sector on the financial sector.

Income From Prop Trading:Prop Trading at Goldman Sachs

Gambling vs. Functionally Efficient Activities
Five Large Investment Banks

GS (Goldman Sachs)	1998	1999	2000	…	2006	2007	2008
millions $							
Commissions	1,368	1,522	2,307				
Trading and principal investments	2,379	5,773	6,627		25,562	31,226	9,063
Securities services	730	772	940		2,180	2,716	3,422
Net revenue	8,520	13,345	16,590		37,665	45,987	22,222
"Gambling" as a share of net revenue, %	**52.5**	**60.4**	**59.5**		**73.7**	**73.8**	**56.2**

Note. Gambling = commissions + trading and principal investment + securities services, for 1998-2000, and gambling = trading and principal investment + securities services, for 2006-2008, due to a change in methodology.

Source: Crotty, Epstein, Levina, SAFER, 2009

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Income from Prop Trading: Bear Stearns

BSC (Bear Stearns)	1993	1994	1995	.....	2005	2006	2007
millions $							
Commissions	421	483	547		1,200	1,163	1,269
Principal transactions	1,157	1,134	860		3,836	4,995	1,323
Net revenue	2,143	2,417	2,075		7,411	9,227	5,945
"Gambling" as a share of net revenue, %	**73.6**	**66.9**	**67.8**		**68.0**	**66.7**	**43.6**

Note. Gambling = commissions + principal transactions.

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Lehman

LEHM (Lehman)	1989	1990	1991	1992	1993	.....	2005	2006	2007
millions $									
Commissions	1,858	1,508	1,649	1,677	1,316		1,728	2,050	2,471
[Market making and] principal transactions	1,269	1,199	1,696	1,697	1,967		7,811	9,802	9,197
Net revenue	4,892	4,016	4,905	5,426	5,218		14,630	17,583	19,257
"Gambling" as a share of net revenue, %	**63.9**	**67.4**	**68.2**	**62.2**	**62.9**		**65.2**	**67.4**	**60.6**

Note. Gambling = commissions + [market making and] principal transactions.

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It is crucial to use language in the Volcker Rule Intended to investigate whether even permitted activities should be prohibited due to the risks they raise for over-all financial stability.

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Volcker Rule

states that, "No transaction, class of transactions, or activity may be deemed...permitted...if it (i) would involve or result in a material conflict of interest...(ii) would result, directly or indirectly in material exposure by the banking entity to high-risk assets or high-risk trading strategies...(iii) would pose a threat to the safety and soundness of such banking entity; or (iv) would pose a threat to the financial stability of the United States." (Dodd-Frank Act, Section 619(d)(2)(A)(i – iv).)

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Take “Market Making”, for example

Under “market-making”, new, toxic products can be designed and then customers are sought out to buy them.

This is not “market-making” in the sense that there is a body of prior customers seeking a market in particular products.

In true market making, the revenue would be gleaned primarily from bid-ask spreads

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Financial Stability Considerations suggest:

- **Careful and prior scrutiny of products that ostensibly serve to make markets in this sense.**

- **To carefully study the funding mechanisms for such market facilitation. Liquidity and maturity mismatch concerns have to accompany a Volcker Rule implementation that implement the law and place importance on financial stability.**

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Stifle Financial Innovation?

Critics will claim that such strict application of financial stability concerns will stifle financial innovation.

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Financial Innovation: beyond the ATM?

Volcker was right: the surveys of financial innovation cannot find link between financial innovation and economic growth

Empirical Estimates of impact of Financial Innovation on Growth, Productivity

White and Fame 2004 JEL survey article:

“Very little empirical evidence on the impact of financial innovation”.

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Studies of New Security Issues

Motives for Financial innovation (Finnerty, Tobin, et. al):

(1) reallocating risk

(2) increasing liquidity

(3) reducing agency costs

(4) reducing transactions costs

(5) reducing taxes

(6) circumventing regulatory constraints

(7) gaining first mover-advantages

(8) open new venue for speculation (casino motive)

(9) redistribute income from other stakeholder or customer

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Motivations for Financial Innovation Finnerty Studies

Study	Total Number of Security Innovations (1)	Number motivated at least partly be tax or regulatory reasons (2)	**Percentage of total innovations motivated by tax or regulatory reasons (2)/(1) x 100 (%)**
Finnerty, 1988	103	45	**44**
Finnerty, 1992	65	21	**34**
Finnerty and Emery, 2002	80	25	**31**

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Conclusions:

- **Risky Proprietary Trading involves very serious systemic risk concerns**

- **Even "permitted activities", such as "market-making activities" must be intensively scrutinized to limit or place higher capital charges and liquidity limits in order to protect tax-payers and workers from the massive costs of new failures.**