Bankers question definition of 'prop trading' at Senate Volcker rule hearing

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Senior bankers and academics have questioned the feasibility of new rules to prohibit US bank holding companies from engaging in proprietary trading, pointing to the difficulty of defining the activity and the limited impact such a ban could have as a systemic risk mitigant.

In the second hearing on the so-called Volcker rule, the Senate Banking Committee received testimony from Gerald Corrigan, chairman of Goldman Sachs, who claimed no more than 10% of the bank's revenues come from proprietary trading. He also warned a clear delineation of proprietary trading would be vital to any new powers and suggested regulators already have the tools they need to tackle reckless institutions individually.

“There are many important definition details that still need to be clarified. I think it is theoretically possible to construct a tight regime from a limited class of activities that you could call proprietary trading where there is absolutely no interaction whatsoever between a group of proprietary traders and clients and where that activity is totally walled off within a given institution,” he said.

The Volcker rule was announced by the Obama administration on January 21, and aims to prevent banks from engaging in proprietary trading if they also benefit from federal protection on customer deposits and access to the Federal Reserve discount window. Additionally, those institutions would no longer be permitted to own, sponsor or invest in hedge funds or private equity funds, which are seen as potential venues for pseudo-proprietary trading.

Committee chairman Chris Dodd asked the panel whether it would be possible for the Senate to draft “ironclad” legislation that would work to prohibit proprietary trading. Panelists agreed it could be done in theory, but said the effectiveness of such an injunction would hinge upon the willingness of senior management to enforce it.

“If you say to a financial institution that proprietary trading is not an acceptable practice, any well-managed firm knows how to run its business in such a way as to not be engaged in proprietary trading. People who argue that you cannot find this out have not run these types of institutions,” said John Reed, former chairman and chief executive at Citigroup.

Despite objections to the Volcker rule on the basis of definitions and practical implementation, the most stinging criticisms came from the two academics on the panel, who noted the minor impact the prohibition could have on the US banks with the largest depositor bases.

“If the limits on proprietary trading only apply where banks take positions unrelated to serving customers they will have little impact. For example, with respect to Wells Fargo and Bank of America, such activity represents around 1% of revenues. While proprietary trading has been

estimated to be 10% of the revenues of Goldman Sachs, that firm could easily avoid these requirements by divesting itself of its banking operations as deposit-taking constitutes only 5.19% of its liabilities," said Hal Scott, professor of international financial systems at Harvard Law School.

Scott concluded his prepared remarks by attacking Economic Recovery Advisory Board chairman Paul Volcker's confidence that international consensus receptive to the proposed rule exists in the UK and elsewhere.

"These proposals have not been agreed to even in principle by the Group of 20 or major market competitors, unlike the other proposals the House of Representatives has considered and that are currently before this committee," asserted Scott. "While international organisations have been polite in 'welcoming' these proposals, they have not endorsed them. Without international consensus, adopting these proposals will only harm the competitive position of US financial institutions."