Doubts grow about inclusion of Volcker rule in Senate bill

Risk Magazine
By Peter Madigan
March 4, 2010

The White House sent legislative language outlining its contentious 'Volcker rule' to Congress on Wednesday, which is designed to prevent bank holding companies from engaging in proprietary trading. However, doubts remain about the need for such a rule, with increasing numbers of participants speculating it will be scrapped.

A six paragraph summary of the legislative proposal offered some additional detail on what was originally announced by President Obama on January 21. The document proposes to ban bank holding companies from "purchasing or selling, or otherwise acquiring or disposing of, stocks, bonds, options, commodities, derivatives, or other financial instruments for the institution or company's own trading book, and not on behalf of a customer, as part of market-making activities, or otherwise in connection with or in facilitation of a customer relationship (including hedging activities related to the foregoing)".

Other elements included in the proposal were not featured in the original Obama announcement in January, including plans to forbid banks from offering prime brokerage services to private equity and hedge funds they advise, or to bail them out. Banks may still act as investment advisers to these firms - although they cannot both advise and act as a prime broker to a fund.

The document also confirmed that non-bank firms would be permitted to continue to engage in proprietary trading, albeit under "tough supervision and oversight" and with "more stringent capital and liquidity requirements".

However, in the last week of February, a variety of US news sources quoted unnamed officials close to and inside the Treasury department who expressed doubt the Senate would agree to include the Volcker rule in legislation currently being thrashed out by the Senate Committee on Banking, Housing and Urban Affairs.

That speculation led reporters to question whether the Obama administration is softening its position on the Volcker rule during a media briefing on February 23.

"Absolutely not," said White House press secretary Robert Gibbs. "The administration remains as committed today to what was outlined that day with chairman Volcker and members of the economic team. We're not walking away from and we're not watering down that proposal one bit."

That opinion may not be shared by senators, however. Hal Scott, Nomura professor and director of the programme on international financial systems at Harvard Law School in Massachusetts, says he detected a distinct lack of enthusiasm among committee members when he testified before the Banking Committee on February 4.

"My sense from participating in the hearing and listening to what the Banking Committee had to say was that I could not identify one senator there that day who thought the Volcker rule would help matters much," he says.

Others have objected to the proposals on the basis such a ban would have little impact in mitigating systemic risk.

In a January 27 research note, analysts at Morgan Stanley estimated the likely impact would vary from a 1% reduction of revenues at Royal Bank of Scotland (based on prop trading constituting 5% of all trading activity) to an 8% reduction in revenues at Deutsche Bank (based on prop trading constituting 15% of all trading).

As such, former regulators continue to question the necessity of implementing the Volcker proposals, while some even fear the loss of revenues from speculative trading could have the perverse effect of driving banks into even riskier practices to make up for lost revenue.

"What kind of unintended consequences could prohibiting proprietary trading have? It could drive banks to lend long to increasingly poor credits, because banks will fight for the right to lend to good credits. Also, as they search for new revenue streams, this rule will concentrate bank activities. We could be setting ourselves up for another crisis," says Paul Atkins, a partner at Washington, DC-based compliance consultancy Patomak Partners and a former commissioner at the Securities and Exchange Commission from 2002 to 2008.

"I don't think proprietary trading itself is where the risks are, especially if you look at the small percentage of bank revenues that come from that space. I think banks aren't judging their credit properly and they're not calculating their exposure correctly, and that is where the next time bombs are lurking in the system," Atkins says.