The Dodd-Frank regulatory reform act in the US gives banks plenty of time to adjust to its Volcker Rule, the disallowance of proprietary trading.

The law itself provides them with lots of wiggle-room, with implementation left to the Financial Stability Oversight Council, which recently released a study it was required to make about the new rules.

Next, the FSOC will have to finalise the rules (expected in June) and circulate them for discussion and push-back from lobbyists. Then there will be a lengthy period allowed for the banks to put them into effect. It could all take years.

The FSOC study acknowledges that the distinction between “permissible” and “impermissible” trading may be difficult to make. Market-making, for example, is allowed under Dodd-Frank. This is defined by the banks as trading with or on behalf of clients.

The banks say there is no proprietary trading if any position held was acquired assisting a client. Also, virtually all trading today is financed in the market, through the repo or secured loan markets, so prop trading is hard to identify simply as being financed by a firm’s own money.

At first glance, the 79-page study seems like a typical government entanglement in details. But read more carefully, the study suggests the regulators really do get it, and may actually have found a way to regulate this type of trading effectively.

What matters to regulators is the risk associated with trading positions, and whether such risks are held for extensive periods, as the concentrated mortgage-backed securities positions were at UBS, Bear Stearns, Lehman Brothers, Merrill Lynch and Citigroup.

What the regulators have noticed is that distinguishing between permissible and impermissible trading may be unnecessary if, instead, they place reasonable limits on particular trading strategies, concentrations in particular asset classes, and/or turnover of trading inventories as a whole.

They might establish, for example, that no bank can maintain more than, say, 10% of capital invested in spread trades, or collateralised securities, or hold inventories for longer than 60 days.

If such rules had been in effect in 2007, and extended to systemically important non-banks as Dodd-Frank now requires, the banking crisis of the following year might not have occurred.
But even if the final rules are more watered down than this, the imposition of Basel III (and its growing list of extensions to cover liquidity, leverage and a “countercyclical capital buffer”, and extra “enhancements” for systemically important firms) makes holding trading assets very expensive compared with competitors not subject to the same rules.

Hot-shots are moving on

The large banks have got the message that the intensity of their trading activities will have to be reduced in the future. That being the case, many hot-shot traders have already sized up the situation and voted with their feet.

The markets too have reacted to Dodd-Frank, fearing higher capital costs and regulatory restrictions. The stock prices of the five leading US capital market banks (including Goldman Sachs and Morgan Stanley) averaged only 0.96 of book value at year end, well down from the 2-3 times ratio that applied before the crisis, despite a generally positive market outlook for 2011.

The low stock prices reflect, among other things, considerable uncertainty about the future of trading, which has contributed between 25% and 80% of revenues for these firms in recent years.

Last month Goldman Sachs, the dominant trading firm, announced in its Business Standards Committee Report that it would disclose a new business segment for “investing and loans” (prop trading, investments in hedge funds, real estate, private equity and bank loans combined), but the new business segment (including some things permitted under Volcker) accounted for just 19% of 2010 revenues.

The firm has closed some of its proprietary trading activities and apparently allowed the rest to wither with many of its traders departing to join or set up hedge funds.

Morgan Stanley has announced that it will end or spin off its last proprietary trading business in 2012. JP Morgan, Citigroup and Bank of America, for which proprietary trading has not been quite so important, also appear to be winding down the activity.

But later this year, when the final Volcker Rules emerge, further adaptations will likely occur. Some trading related business units might be sold or spun off, along with ownership of hedge funds and private equity units. Or they will be compressed and adapted to become something different from what they are now.

In the end, former Fed chairman Paul Volcker, who proposed the rule, may have the last laugh – many belittled his proposals when they were first made – as the banking industry shifts back to being more like what it was before the repeal of Glass Steagall in 1999.

It is OK, Volcker said, for banks to be in the securities business as service providers and lenders, but not as disproportionate risk-takers at the public expense. It may be that between the FSOC and Basel III, this is what will happen.

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