

Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds

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Comment letter submitted by Simon Johnson¹

Please find attached – and regard as part of this comment – my testimony in January 2012 to subcommittees of the House Committee on Financial Services, with regard to implementation of the proposed “Volcker Rule” (Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act; P.L. 111-203).

My position is that the proposed rule broadly strikes the right balance and would help strengthen financial stability in the United States and globally – which is the definite legislative intent behind the Dodd-Frank financial reform act. In the attached testimony I also emphasize the need for regulators and supervisors to enforce the new rules effectively. Given the repeated pattern of “cognitive capture” displayed by many regulators in recent decades, we should worry about the ability of major Wall Street firms to argue that they do not need close supervision.²

The relevant regulators have taken on board a great deal of industry comment already with regard to the Volcker Rule, and much of the specific detail in the rule is as a direct result of requests for clarification from financial sector executives. It is unfair and unreasonable – although unsurprising – that some of the same special interests now claim the proposed rule is too complicated.

Hopefully, you will resist their stalling tactics and begin to implement a meaningful rule this summer. To do otherwise would be to give in to egregious lobbying. Big Wall Street banks are very powerful but they have also done great damage to the American economy. Congress has clearly and unambiguously mandated you to stand up to them. If you are not able to carry out this task, there is serious trouble ahead?

In addition to my recent congressional testimony, I would like to address one additional point that has gained salience in recent weeks.

¹ Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of <http://BaselineScenario.com>.¹ For additional affiliations and disclosures, see <http://baselinescenario.com/about/>.

² The history and extent of cognitive capture in this area is documented at length in Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown* (Pantheon, 2010).

Some foreign central banks are apparently arguing that implementation of the Volcker Rule as proposed would “hurt” their government bond markets, primarily by reducing the liquidity in these markets.

I am skeptical that we will observe any such impact. Most participants in the market will be unaffected by the Volcker Rule. Big banks can still be involved as underwriters of government debt and they can still hold such debt in their “banking book”. Restrictions on their proprietary trading activities are very unlikely to affect either prices or spreads in a significant manner.

The studies on this point produced and paid for by SIFMA argue to the contrary, but these are completely unconvincing. As I review in my testimony, the methodology used by the Oliver Wyman study is stretched beyond reasonable bounds. These results are greatly exaggerated, in part because there is no consideration given to the amount of entry likely to occur in these markets – if the provision of liquidity is really valuable. There is no reason to believe that big Wall Street banks have a monopoly on the relevant forms of expertise or technology or anything else.

Furthermore, where exactly would we draw the line between “safe” and “not safe” foreign government debt? We know that ratings agencies are routinely mistaken in their assessment of sovereign credit risk – this has been the case in almost every major crisis in recent decades. The European Union would like an exemption from the Volcker Rule for the debt of its member governments – yet Greece is already effectively in default and several other countries are likely to follow.³ Japan has expressed interest in an exemption from the Volcker Rule – yet its net debt is reckoned to be over 120 percent of GDP; this is a highly indebted country. It would be foolish to grant any kind of waiver from the Volcker Rule to a country with such a high debt level.

If one or more foreign governments would care to indemnify the US against losses incurred by our largest banks due to trading in their debt, this could be the basis of an interesting negotiation. For example, Canada is asking to be exempted from the Volcker Rule. But would Canada be willing to pledge its IMF quota – or other reserve-type holdings, preferably denominated in US dollars – to make good any losses classified under proprietary trading by big US banks (i.e., that would otherwise be covered by the Volcker Rule)? Any such assets would need to be held in escrow, otherwise there would be a very real risk that, when the time came to collect, the countries in question would be unable to pay – for example, imagine what would now be the situation if US banks held a large amount of Greek government debt?

³ On the imminent dangers in Europe, including sovereign default, please see Peter Boone and Simon Johnson, “The European Crisis Deepens,” Policy Brief, Peterson Institute for International Economics, PB12-4, January 2012, <http://piie.com/publications/pb/pb12-4.pdf>.

Testimony submitted to the House Financial Services Committee, Joint Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit Subcommittee Hearing on “Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation,” January 18, 2012.

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of <http://BaselineScenario.com>.¹

A. General Points

- 1) Sound principles lie behind the “Volcker Rule” (Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act; P.L. 111-203).² Very large banks in the United States are perceived as “too big to fail”, because their failure would likely cause massive damage to the rest of the financial system. As a result, the downside risks created by these institutions are borne, in part, by the government and the Federal Reserve – as a way to protect the rest of the economy.
- 2) In effect, these banks benefit from unfair, nontransparent and dangerous government subsidies that encourage reckless gambling. When things go well, the benefits of these arrangements are garnered by the executives who run these firms (and perhaps shareholders). When things go badly, the downside costs are pushed in various ways onto the taxpayers and all citizens.
- 3) These costs are huge. For example, the increase in federal government debt (held by the private sector) as a direct result of the financial crisis is estimated by the Congressional Budget Office as likely to end up over 40 percent of GDP.³ In addition, the financial crisis destroyed more than 8 million jobs and seriously disrupted the lives of ordinary Americans in many other ways.
- 4) Megabanks with a great deal of debt and little equity (i.e., dangerously low capital levels) are prone to major collapses.⁴ These structures create a nontransparent contingent liability for the

¹ This testimony draws on joint work with James Kwak, particularly [13 Bankers: The Wall Street Takeover and The Next Financial Meltdown](#) and [White House Burning: The Founding Fathers, Our National Debt, and Why It Matters To You](#) (forthcoming April 2012), and Peter Boone, including [Europe on the Brink](#). Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at <http://BaselineScenario.com>, where we also provide daily updates and detailed policy assessments for the global economy. For additional affiliations and disclosures, please see this page: <http://BaselineScenario.com/about/>.

² See <http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf> and the proposed Rule at <http://fdic.gov/news/board/2011Octno6.pdf>.

³ To measure just the fiscal impact of the finance-induced recession, compare changes in the CBO’s baseline projections over time. In [January 2008](#), the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to \$5.1 trillion by 2018 (23% of GDP). As of [January 2010](#), the CBO projected that over the next eight years, debt would rise to \$13.7 trillion (over 65% of GDP)—a difference of \$8.6 trillion. Of the change in CBO baseline, 57% is due to decreased tax revenues resulting from the financial crisis and recession; 17% is due to increases in discretionary spending, some of it the stimulus package necessitated by the financial crisis (and because the “automatic stabilizers” in the United States are relatively weak); and another 14% is due to increased interest payments on the debt – because we now have more debt.

⁴ There is nothing in the Basel III accord on capital requirements that should be considered encouraging. Independent analysts have established beyond a reasonable doubt that substantially increasing the

federal budget in the United States. They also damage the nonfinancial business sector both directly – e.g., when there is a credit crunch, followed by a deep recession – and indirectly through creating a future tax liability.

- 5) The funding advantage of megabanks relative to other financial institutions creates an incentive to become even larger and even more global – thus making them even harder to control and more dangerous in an economic downturn (as seen now in Europe’s euro area).
- 6) One major mechanism through which banks gamble is through various forms of “proprietary trading,” although this risk-taking is not always accurately described as such when banks report on their activities.
- 7) The legislative intent of the Volcker Rule is to clamp down on these activities, forcing the largest banks to become safer.
- 8) Not surprisingly, there is a great deal of pushback from these banks, arguing that the Volcker Rule will create costs for the broader economy. These concerns are exaggerated and the evidence in support of the banks’ main propositions is tenuous at best. Such defenses of existing banking practices also neglect the costs imposed on the broader economy due to the financial crisis – and hence the benefits we can gain from limiting the ability of executives at big banks to destroy their companies and thus damage the economy.

B. Specific Concerns Expressed By Banks

First, bankers express concern that the Volcker Rule would discriminate against “safe” foreign sovereign debt. But if a bank is holding sovereign debt as a classic long-term banking investment, then this is in the “banking book” and hence not prohibited under the Rule.

Similarly, if a bank is underwriting or market-making for sovereign debt, then this is also a permitted activity. The only restriction in question is whether a US banking entity can purely “prop trade” sovereign debt, i.e., buying and selling (or engaging in derivative transactions) for the purpose of short-term capital gain.

Proprietary trading in foreign sovereign debt is inherently risky. This is exactly the kind of gambling that led to the recent demise of MF Global. Just because someone claims that the debt of a foreign government is “safe” does not mean that is true. In fact, financial history is full of examples in which investment bankers (including those based in the U.S.) miscalculate or make exaggerated claims regarding sovereign risks. This point is only reaffirmed by recent experience in Western Europe, for example for Greece and Italy.

U.S. government debt is treated differently under the Rule – and this is appropriate. Trading in U.S. government securities was principally included as a permitted activity because treasuries are the major instrument used by banks as collateral for a range of transactions and for asset-liability management. No further statutory extension or definition of permitted activity for Treasuries is needed – and the same holds for municipal debt. Underwriting and market-making are already permitted, and classic “banking book” holdings are also permitted for U.S. government debt.

Second, there is concern that the Volcker Rule would hurt liquidity and capital markets. In this regard, some attention is being paid to a report by Oliver Wyman, “The Volcker Rule:

required equity funding for large banks (i.e., their capital) would not be costly from a social point of view (e.g., see [the work of Anat Admati of Stanford University and her colleagues](#)).

Implications for the US corporate bond market,” commissioned by the Securities Industry and Financial Markets Association (SIFMA).⁵

The current chair of SIFMA is Jerry del Missier, a top executive at Barclays Capital.⁶ The board also includes executives from Morgan Stanley, Societe General, UBS, BNP Paribas, HSBC, Deutsche Bank, Goldman Sachs, Citigroup, RBS, JP Morgan Chase, Credit Suisse, RBC, and Merrill Lynch. All of these companies would be affected by the Volcker Rule (according to the Oliver Wyman report, p. 11).

The Volcker Rule is designed to remove subsidies from large banks that also operate proprietary trading at any significant scale. We should expect executives from these firms to oppose removal of these subsidies. To the extent that such subsidies may be expected to benefit shareholders, it can be argued that these executives also have a fiduciary responsibility to do all they to ensure the subsidies continue (i.e., that the effectiveness of the Volcker Rule be undermined).

SIFMA’s statement of its mission is clear: “On behalf of our members, SIFMA is engaged in conversations throughout the country and across international borders with legislators, regulators, media and industry participants.”⁷ There is nothing in their public materials to suggest the research they sponsor is designed to uncover true social costs and benefits; rather their goal is to advance the interests of their members – this is a lobby group. SIFMA claims to represent the entire securities industry but more than 1/3 of its board is drawn from very large banks that would find their implicit subsidies cut and constrained by an effective Volcker Rule. Given this context, it is not clear why the Olivier Wyman study would be regarded as anything other than a form of special interest lobbying.

There is also a serious methodological issue. The Oliver Wyman study draws heavily on a paper by Jens Dick-Nielson, Peter Feldhutter, and David Lando, which looks at the liquidity premia for corporate debt.⁸ The Olivier Wyman study claims that the Volcker Rule will make corporate bonds less liquid and therefore increase interest rates on such securities, but their approach assumes the answer – which is not generally an appealing way to conduct research.

Specifically, the Oliver Wyman study assumes that every dollar disallowed in pure proprietary trading by banks will necessarily disappear. But if money can still be made (without subsidies), the same trading should continue in another form. For example, the bank could spin off the trading activity and associated capital at a fair market price. Alternatively, the trader – with

⁵ <http://www.sifma.org/issues/item.aspx?id=8589936887>. The report is available on the SIFMA webpage that contains its comment letters to regulators. On p. 36 of the report, the disclaimer begins, “This report sets forth the information required by the terms of Oliver Wyman’s engagement by SIFMA and is prepared in the form expressly required thereby.” The precise terms of this engagement are not stated in the document.

⁶ <http://www.sifma.org/about/board-and-officers/>

⁷ <http://www.sifma.org/about/join-sifma/>

⁸ <http://www.feldhutter.com/BondLiqFinalPaper.pdf>. This paper shows, “Illiquidity premia in US corporate bonds were large during the subprime crisis. Bonds become less liquid when financial distress hits a lead underwriter” (<http://www.feldhutter.com/>).

valuable skills and experience – will raise outside capital and continue doing an equivalent version of his or her job.

If there is money to be made absent “too big to fail” subsidies, then an efficient capital market would suggest that the traders and the associated capital will remain engaged in some form. Now, however, these traders will bear more of their own downside risks. If it turns out that the previous form or extent of trading only existed because of the implicit government subsidies, then we should not mourn its end.

The Oliver Wyman study further assumes that the impact of the Volcker Rule will be similar to the financial crisis, and then seeks to measure that. This is ironic, given that the financial crisis severely disrupted liquidity and credit availability more generally – in fact this is the point of the Dick-Nielson, Feldhutter, and Lando paper.

The Volcker Rule may actually support more liquid markets by ensuring that the banks focus on providing liquidity as market-makers – rather than draining liquidity from the market in the course of “trading to beat” institutional buyers like pension funds, university endowments, and mutual funds.

More generally, Thomas Philippon finds limited or no social benefits from increased trading activities *per se*.⁹ And the biggest disaster for the corporate bond market in recent years was a direct result of excessive risk-taking by big financial players.

C. The Proposed Rule

On the positive side, the proposed Volcker Rule would collect data, enabling regulators to know more about what firms are doing. It sensibly restricts proprietary trading – including by prohibiting traders from being compensated for making proprietary-type bets. There are also restrictions on investments in private funds of various kinds.

However, there is also definite room for Improvement. There are currently insufficiently clear lines on what is permitted; this makes it hard for regulators to enforce and for industry to comply. Much clearer presumptions could be provided – much as the industry does today on some trading desks.

More broadly, under the proposed Rule, firms would be allowed to set their own rules and compliance policies. This is a recipe for inconsistency between firms and loose regulation. If the banks are allowed to create large enough loopholes, the Rule will not be effective and big banks will again be able to use proprietary trading to gamble excessively – with their losses ultimately being borne by the American taxpayer.

⁹ Thomas Philippon, “Has the U.S. Finance Industry Become Less Efficient?”
<http://pages.stern.nyu.edu/~tphilipp/papers/FinEff.pdf>