

Presentation for
the ECB FX
Contact Group
September 2012

The Volcker Rule

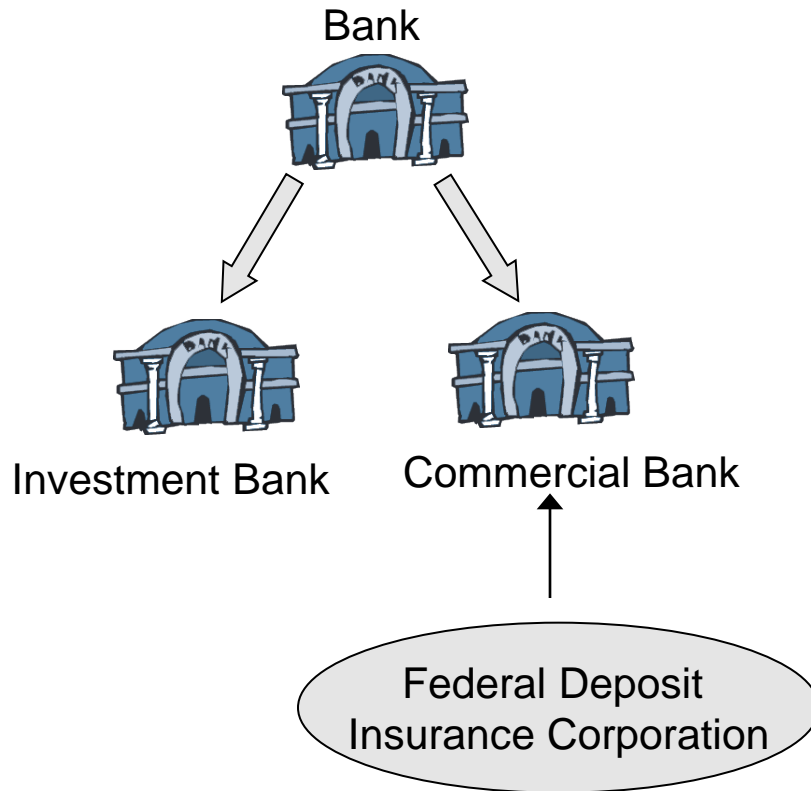
Implications for the FX Market



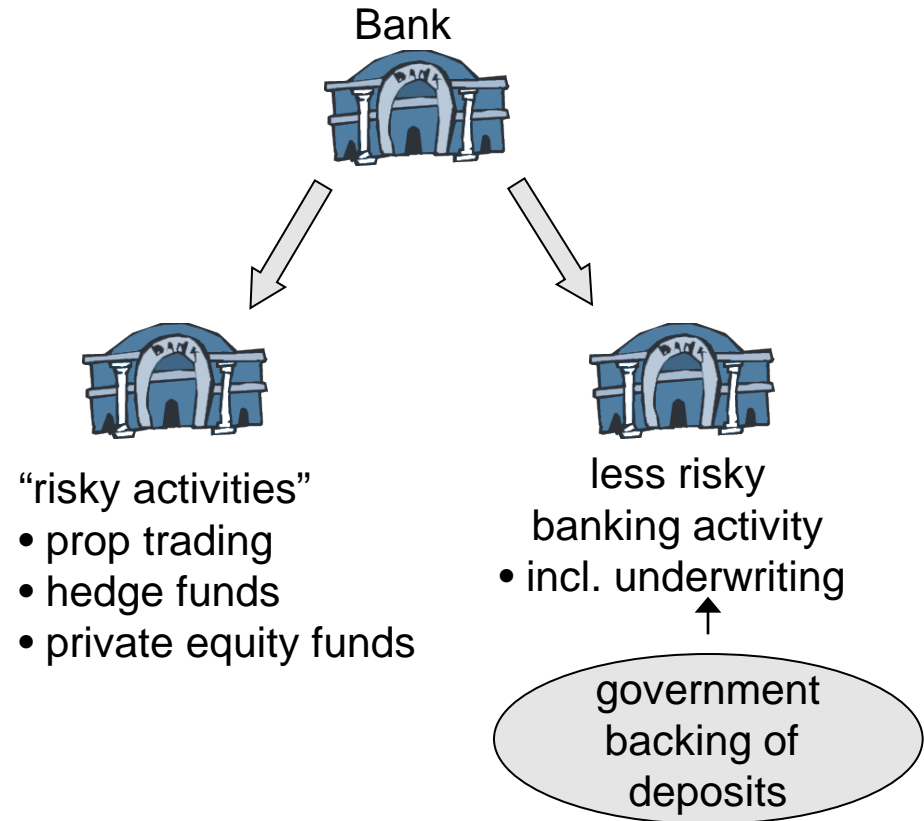
The Volcker rule

General idea: a new version of Glass-Steagall

Glass-Steagall



Volcker Rule





Putting the Volcker Rule into context

- › Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203 - July 21 2010 (Dodd-Frank Act)
 - Section 619: (Volcker Rule) “Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds”.
 - Adds new Section 13 to Bank Holding Company Act of 1956 (BHC Act)
- › Common draft by Department of the Treasury (OCC-2011-0014), Board of Governors of the Federal Reserve System (R-14), Federal Deposit Insurance Corporation, Securities and Exchange Commission.
 - “Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds” (Proposed Rule)

Prop trading & the fx market

§___.3(a) **Prohibition on proprietary trading**

Except as otherwise provided in this subpart, a covered banking entity may not engage in **proprietary trading**.

§___.3(b)(1) Proprietary trading means engaging as principal for the trading account of the covered banking entity in any purchase or sale of one or more **covered financial positions**.

§___.3(b)(3)(i) Covered financial position means any position, including any long, short, synthetic or other position, in: (...) a **derivative**, including an option on a derivative

§___.3(b)(3)(ii) A covered financial position does not include any position that is: (...) **foreign exchange or currency**.

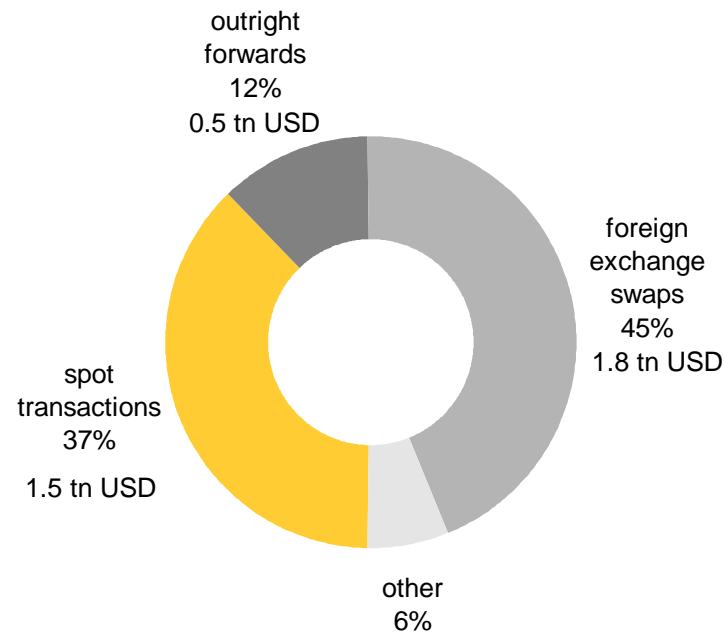
fx forwards, fx swaps, fx options

fx spot

Looking at the global forex landscape

Global forex market turnover by instrument

As % of total, share in tn USD

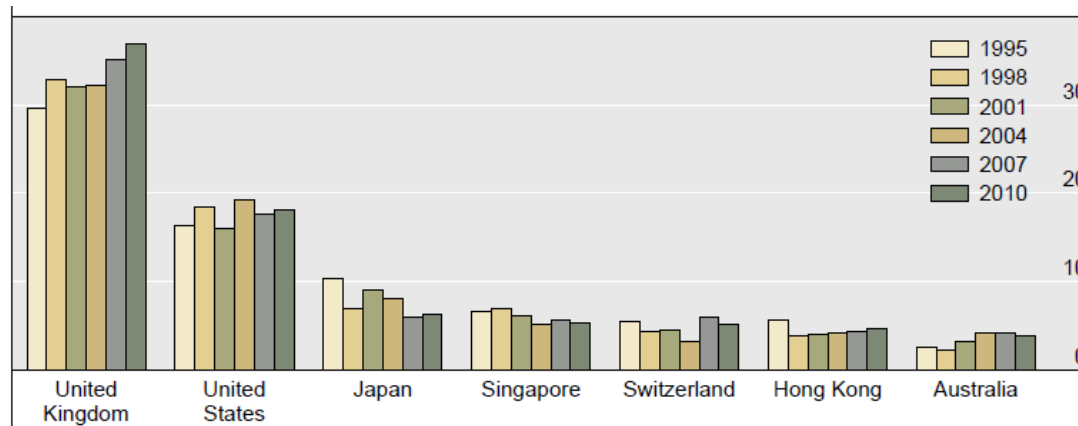


Source: BIS 2010

Looking at the global forex landscape

Geographical distribution of FX market turnover

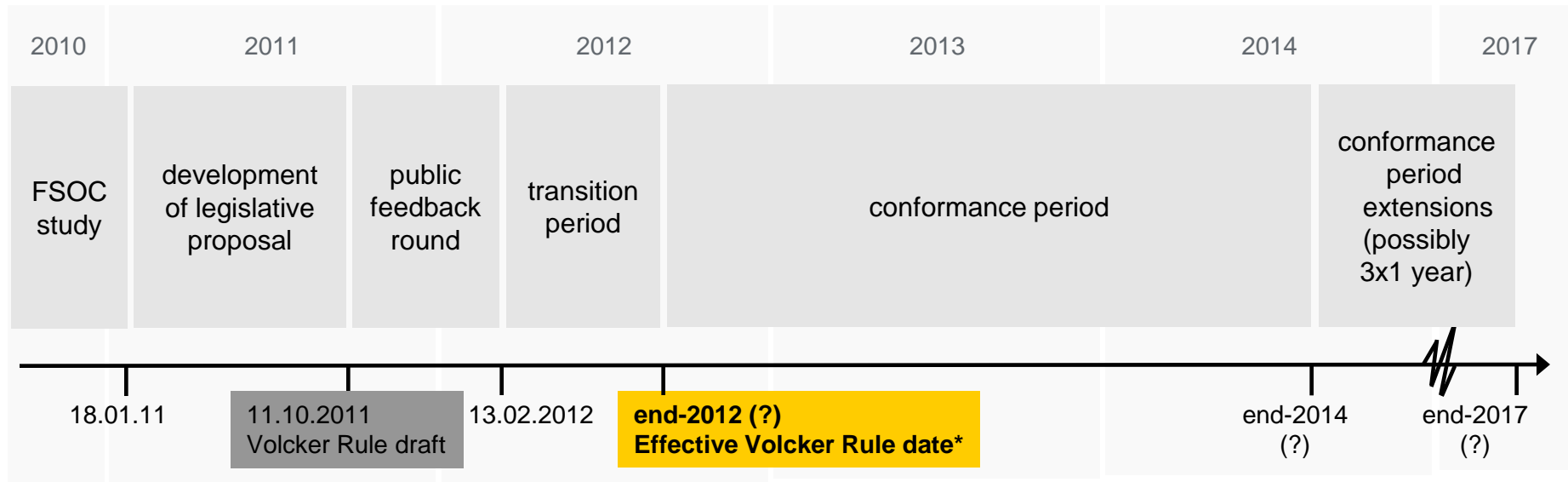
As % of total



Source: BIS 2010



Implementation time line



* „(...) an entity covered by (...) the so-called Volcker Rule, has the **full two-year period** provided by the statute **to fully conform its activities and investments**, unless the Board extends the conformance period.“
Fed press release, April 19 2012

How are European markets affected?

Extraterritorial provisions

The Volcker rule applies to

- › insured depository institutions;
- › any company that controls an insured depository institution;
- › **foreign banks with a branch, agency or subsidiary in the US;**
- › any affiliate or subsidiary of those entities.

Dodd-Frank Act, Sec. 619(h)(1)

Trading outside the US by a foreign bank

- › “The following activities are permitted: [...] Proprietary trading conducted by a banking entity [...], provided that the trading occurs solely outside of the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States [...].” Dodd-Frank Act, Sec. 619(d)(1)(H)
- › “§ __.6(d)(3) A purchase or sale shall be deemed to have occurred solely occurred solely outside of the United States only if [...] no party to the purchase or sale is a resident of the United States; [...] the purchase or sale is executed wholly outside the United States.”



Prohibited vs. permitted trading activity

Prohibited activities

- › Prop trading: “principal” risk in order to benefit from near-term price movements
- › “trader initiated”
- › Identification by “bright line” indicators

Permitted activities

- › Market making, underwriting activities, hedging, transacting in US government securities, and certain other activities specified in Dodd-Frank
- › “customer-initiated”

Additional limitation: “Prudential backstop” (conflict of interest, material exposure to high-risk assets/trading strategies, threat to safety or soundness of banking entity/fin. stability of US)

How to differentiate between prop trading and market making? (1)

The regulators are still uncertain

Six general indicators for prohibited prop trading activities Proposed Rule

- › [...] a trading unit **retains risk** in excess of the size and type required to provide intermediation service to customers;
- › [...] a trading unit **primarily generates revenues from price movements** of retained principal positions and risks, rather than customer revenues;
- › [...] a trading unit: (i) generates only **very small or very large amounts of revenue** per unit of risk taken; (ii) does not demonstrate **consistent profitability**; or (iii) demonstrates **high earnings volatility**;
- › [...] a trading unit either (i) does **not transact through a trading system** that interacts with orders of others or primarily with **customers** of the banking entity's market making desk to provide liquidity services, or (ii) holds principal **positions in excess of reasonably expected near-term customer demands**;
- › [...] a trading unit routinely **pays fees** rather than earns fees, commissions and spreads;
- › the use of **compensation incentives** for employees of a particular trading activity that primarily reward proprietary risk-taking.

How to differentiate between prop trading and market making? (2)

The regulators are still uncertain – but want to define “bright line” criteria

Ideas in the FSOC study

› Revenue-based metrics

- › Historical revenue comparison
- › Day one P&L
- › Bid-offer pay-to-receive ratio

› Inventory metrics

- › Inventory turnover
- › Inventory aging

› Revenue-to-risk metrics

- › Profitable trading days as percentage of total days
- › Sharpe ratios

› Customer-flow metrics

- › Customer-initiated trade ratio
- › Customer-initiated flow to inventory
- › Revenue to customer-initiated flow ratio

How to differentiate between prop trading and market making? (3)

The regulators are still uncertain – but want to define “bright line” criteria

Questions in the Proposed Rule

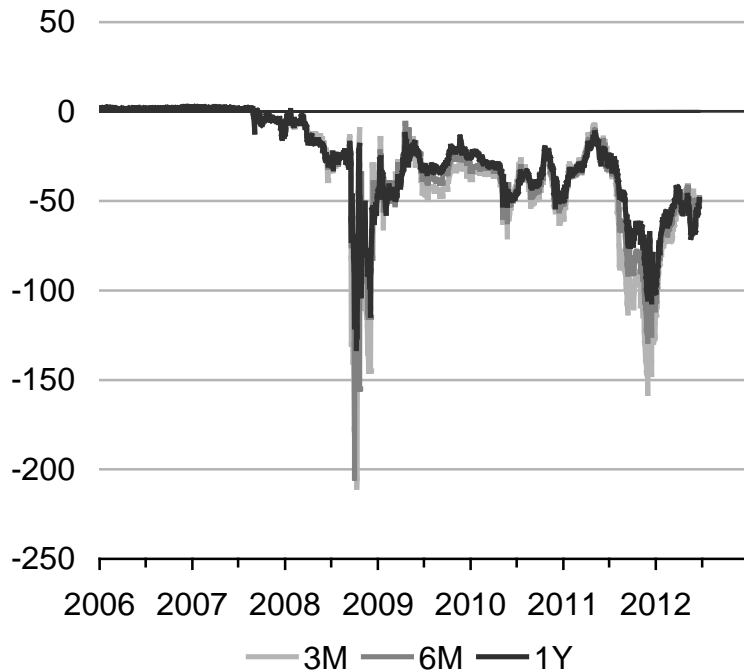
- › Increase in VaR, Stress VaR, Risk Factor Sensitivities
- › $(\text{Comprehensive P\&L}) / (\text{Portfolio P\&L} - \text{Spread P\&L})$
- › $[(\text{Comprehensive P\&L}) / (\text{Volatility})] / [(\text{Portfolio P\&L}) / (\text{Volatility})]$
- › $[\text{number of Unprofitable Trading Days based on } (\text{Portfolio P\&L}) / (\text{Volatility})] / [\text{number of Unprofitable Trading days based on } (\text{Comprehensive P\&L}) / (\text{Volatility})]$
- › Pay-to-Receive Spread Ratio

Consequences for the FX market

Further de-coupling of spot and swap market - i.e. no return to CIP?

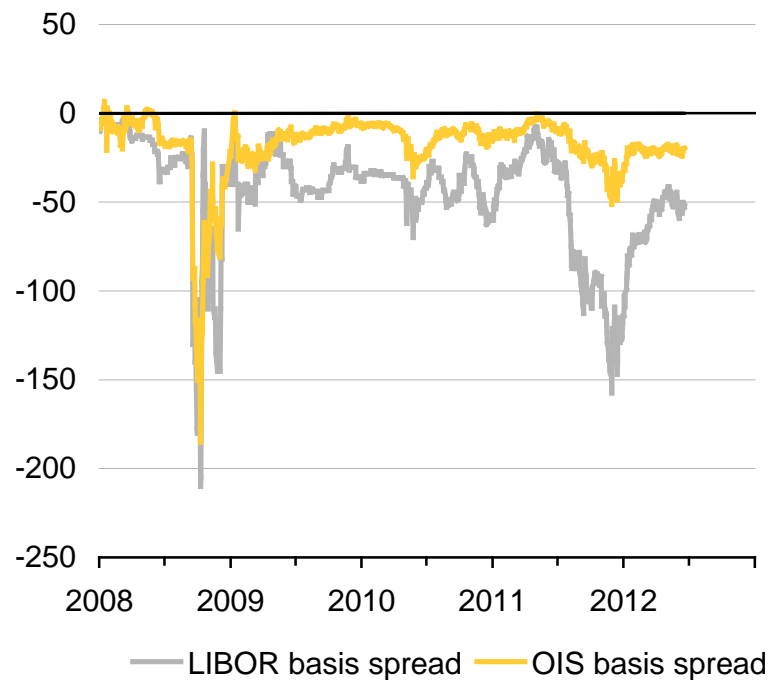
EUR-USD LIBOR basis spread

basis points



LIBOR basis spread vs. OIS basis spread

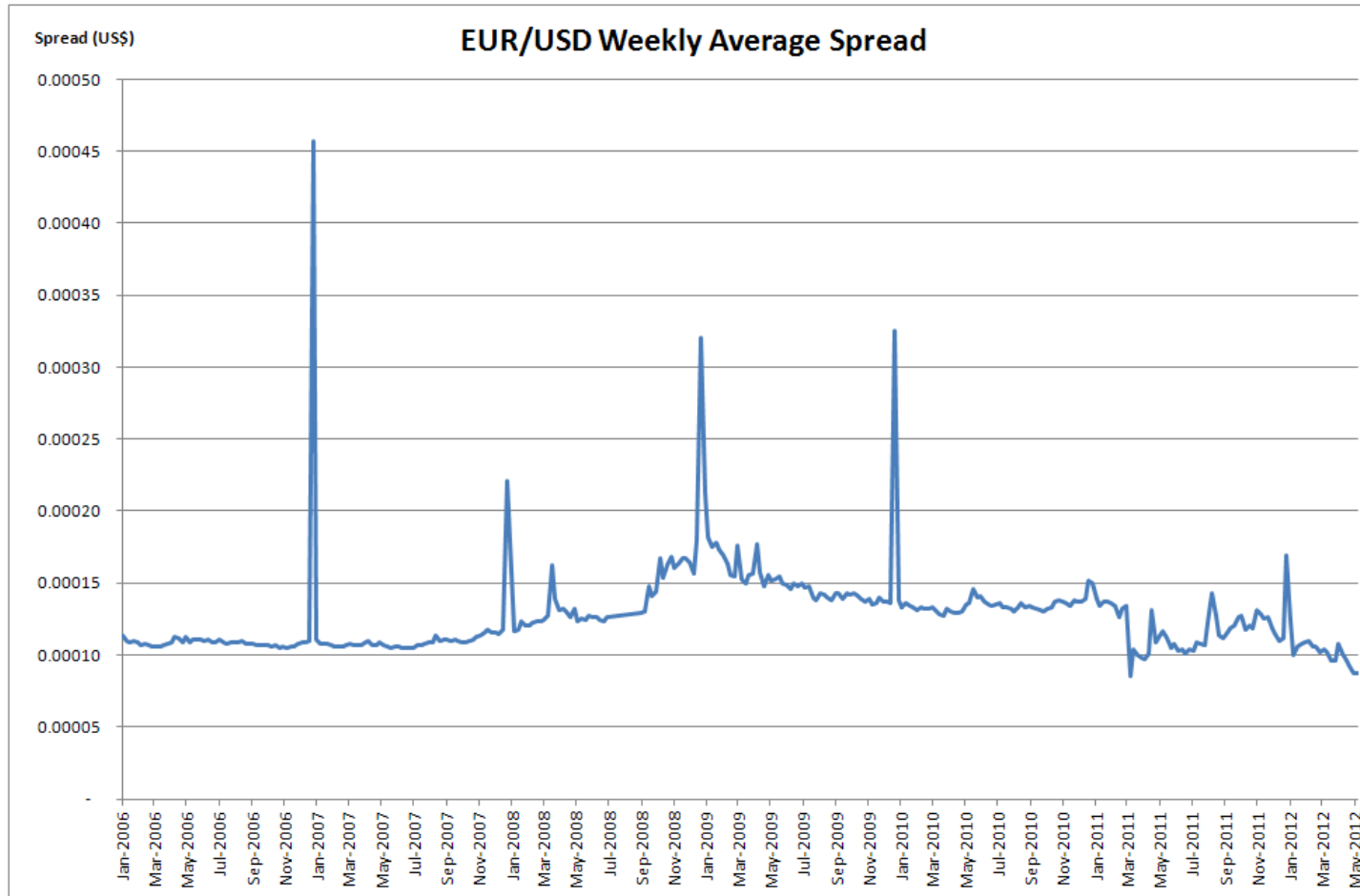
basis points



Sources: Bloomberg, Commerzbank Research

Spreads are compressing

...when crisis risk abates



Source: EBS

A model for the effect of the Volcker rule

The effect on spreads and on US banks' market share

Assumptions

- › There are $i = 1, \dots, N$ market makers.
- › They face monopolistic competition, i.e. the demand for liquidity for market maker i , D_i , is not totally elastic with respect to changes in the quoted spread s_i . Elasticity is ε_i , with $0 < \varepsilon_i < \infty$.
- › The market making desk generates profits from bid-ask spreads, i.e. the profit is $s_i \cdot D_i$.
- › The flow D_i generates market risk for the market maker. The (negative) value of this risk is $R(D_i)$.
- › Market makers can use the flow information to generate prop trading profit, i.e. Chinese walls between market making desks and prop desks do not work perfectly.
- › Given some flow D_i , the prop desk of market maker i can generate a (risk-adjusted) profit of $f(D_i)$ from this flow information. Flow information becomes increasingly valuable with market size, i.e. $\Phi' > 0$.

Risk-adjusted profit maximization for market maker i :

$$\max_{s_i} \{s_i \cdot D_i(s_i) - R[D_i(s_i)] + \Phi[D_i(s_i)]\}$$

Results:

- › The profit-maximizing spread for market maker i , s_i^* , is given by the FOC

$$[s_i^* - R'(D_i^*) + \Phi'(D_i^*)] / s_i^* = 1 / \varepsilon_i$$

where D_i^* denotes the demand, given the profit-maximizing spread: $D_i^* = D_i(s_i^*)$.

- › The spread is smaller than without prop trading (i.e. in the case of $\Phi' = 0$). **Prop trading reduces spreads.**
- › **An effective implementation of the Volcker rule would increase spreads quoted by US banks.**
- › **US banks would lose market share in FX market making.**

Main findings

For the FX market

- › The Volcker rule bans prop trading activities.
- › The Volcker rule applies only for FX options, forwards and swaps, not for spot.
- › Only US banks and US activities of foreign banks are effected.
- › The separation of prop trading and market making is difficult. A firm set of bright line criteria has not been set up yet.
- › An effective implementation of the rule could increase market separation between spot and forward markets.
- › An effective implementation would increase spreads. US banks would lose market share.

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