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Proposal: 1432 (RIN 7100 AD 82) Reg. V V - Proprietary Trading and Certain Interests In, and Relationships

Subject: Volcker Rule -- Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and R

Comments:

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Proposal: Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships with, Hedge Funds and Private Equity Funds
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Comments:

Re: "Volcker Rule" proposal under section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act As a researcher and observer of the banking industry for 30 years, I would like to put forth the argument that the largest and most destabilizing losses suffered by banks in the 2007-2008 period did not stem from proprietary trading activities, as is commonly thought. Therefore, had the rule been in place in 2007, it would have done little to avert the crisis. Given the potential that the rule might have far-reaching detrimental effects on valuable market-making activities, it might be best to adopt a much more limited interpretation of impermissible activities than is currently proposed. The greater part of the losses originated in the underwriting activities of the hardest-hit banks. Underwriting, which entails creating securities, and holding them for the period that it takes to sell them, of necessity generates proprietary positions. Underwriting, in my opinion, rightly remains a permissible activity under the Volker rule. Unfortunately, positions generated by underwriting activities are held in the trading portfolio because they meet the test of assets held with the intent to sell. Changes in market value of these positions are reported as trading income or loss. As such, these gains/ losses are indistinguishable to readers of financial statements from real proprietary trading losses. Such losses can be significant when markets become dislocated and the distribution processes stalls for an extended period of time. They are not, however, speculative in nature, but rather necessary to the process of intermediating credit. Before the crisis, Citigroup, the then independent Merrill Lynch, and UBS were the leaders in underwriting mortgage CDO's; they produced the largest losses on mortgage related assets. Underwriting structured transactions involves accumulating a "warehouse" of loans or securities sufficient to fill out a pool of assets
of a size that can be distributed in the marketplace. For synthetic CDOs, it means writing the credit default swaps that then become the assets in the pools essentially mimicking mortgage risk. Then it involves structuring pools into a series of tranched securities, each bearing a different portion of the risks of the pool. The two US banks, Citigroup and Merrill Lynch, reported $113 billion of losses on "legacy assets" (meaning primarily mortgage-related assets and leveraged loans) in 2007-8. They accounted for 75% of the total of $151 billion of trading losses on "legacy assets" recorded by the six largest banks

in the US. Their annual reports clearly describe the ways in which their securitization structuring and loan syndication businesses-both underwriting activities-- generated those "legacy assets". Given that the trading losses were concentrated in the two banks, it stands to reason that many of their losses were in fact underwriting losses. Only Morgan Stanley indicates that many of its $10 billion of losses on mortgage securities and leveraged loans during those years were on proprietary trading positions. Even the GAO report on proprietary trading found only $10.5 billion of net losses in 2007-8 from the type of trading positions that can be cleanly identified as proprietary-those put on by the hedge-fund like traders who do not interact at all with clients. It mentions that one institution had two quarterly losses totaling $10.5 billion during that period, so likely that institution was Morgan Stanley, given that the other's losses were either greater or much lower. If identifiable proprietary losses in 2008-9 were $10.5 billion and underwriting-related losses were $113 billion, that leaves only about $39.5 billion of the $151 billion as a maximum for proprietary losses of the more difficult to identify type. Split six ways over two years, that is not the magnitude of loss that would sink any one of those large institutions. It is also good to remember that total trading losses over the two years were only $63 billion for the six firms, meaning that the rest of the trading operations generated $98.5 billion of trading income to offset the losses. If the banking crisis was not in fact triggered by proprietary trading, and identifying the proprietary trading aspects that are ancillary to permissible market-making activities is so difficult, requiring huge expenses in rewriting computer tracking systems and staffing compliance organizations, it argues for a more limited form of the rule. Pure proprietary activities, those conducted by non-client facing traders, are easy to identify. While they have never been known to generate catastrophic losses, neither are they central to a robust banking system serving the American economy, and arguably should be eliminated. For all other trading activities, the internal risk management and external regulatory systems already have extensive regimes for tracking and lmiting the amount of proprietary positioning that can take place. For example, the VaR model results are one measure of proprietary position, but many other measures exist. If this country wants to ensure that banks do not take undue proprietary risks, then perhaps strengthening the internal limit setting practices is more sensible than creating a separate, competing regime.