The Volcker Rule
Implications for the FX Market
The Volcker rule
General idea: a new version of Glass-Steagall

Glass-Steagall

Bank

Investment Bank

Commercial Bank

Federal Deposit Insurance Corporation

Volcker Rule

Bank

“risky activities”

• prop trading
• hedge funds
• private equity funds

less risky banking activity

• incl. underwriting

government backing of deposits
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

- **Spot transactions**: 37% (1.5 tn USD)
- **Foreign exchange swaps**: 45% (1.8 tn USD)
- **Outright forwards**: 12% (0.5 tn USD)
- **Other**: 6%

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.

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 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.”

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

› Revenue-to-risk metrics
  › Profitable trading days as percentage of total days
  › Sharpe ratios

› Inventory metrics
  › Inventory turnover
  › Inventory aging

› 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

› \( \text{(Comprehensive P&L) / (Portfolio P&L – Spread P&L)} \)

› \( \left[ \frac{\text{(Comprehensive P&L)}}{\text{(Volatility)}} \right] / \left[ \frac{\text{(Portfolio P&L)}}{\text{(Volatility)}} \right] \)

› \( \left[ \frac{\text{number of Unprofitable Trading Days based on (Portfolio P&L)}}{\text{(Volatility)}} \right] / \left[ \frac{\text{number of Unprofitable Trading days based on (Comprehensive P&L)}}{\text{(Volatility)}} \right] \)

› 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 \( i = 1, \ldots, N \) market makers.

› They face monopolistic competition, i.e. the demand for liquidity by market maker \( i \), \( D_i \), is not totally elastic with respect to changes in the quoted spread \( s_i \). Elasticity is \( \varepsilon_i \), 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 \( f(D) \) 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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