The Volcker Rule and Financial Innovation

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Risk-Taking on Main Street

- Research shows that normal people are risk-averse
  - They reject bets with payoffs skewed to the downside, even if they are mathematically worth more than upside-skewed bets
- Traditional banks, pension funds etc embody this principle
- Entrepreneurs are different, and drive economic progress, but they are rare and they pay a price for their visions

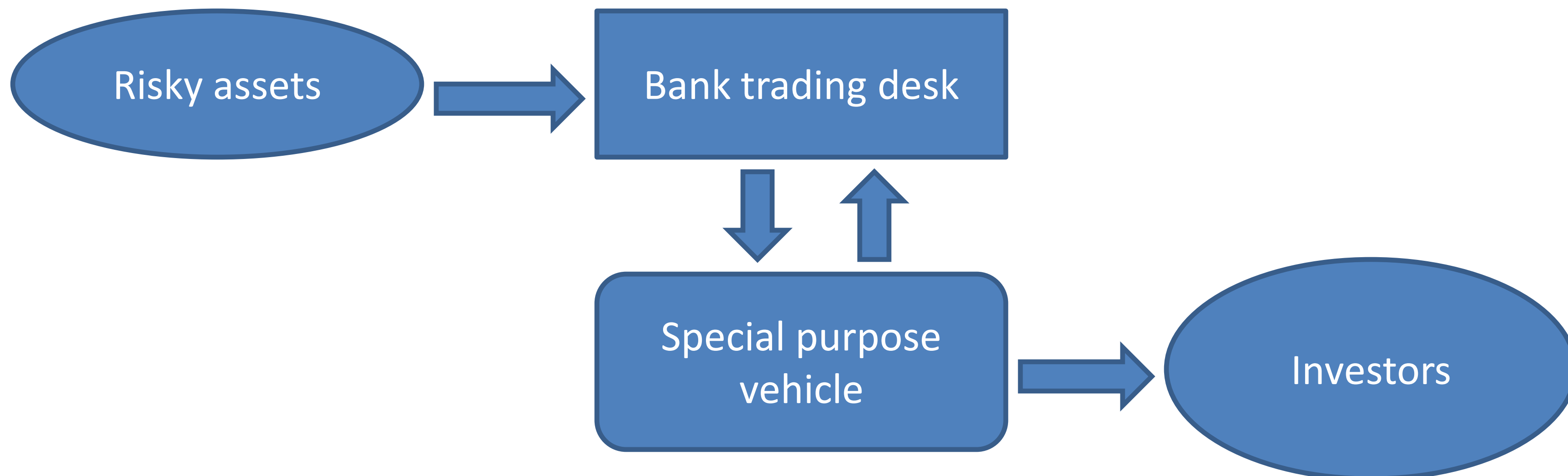
Wall Street's Love-to-Win Credo

- 'Traditional' Wall Street didn't take much risk, and partnership structures kept it that way
- The development of derivatives hedging and securitization technology (1975-95), along with changing bank ownership structures changed this
- Being hedged against the downside changes human psychological perceptions of risk
- To outsiders, Wall St looked the same (underwriting, market-making, asset management) but it became a shareholder-driven, love-to-win machine

How Financial Innovation Changed Wall Street

- From this:

- To this:



Underwriting and Market-Making?

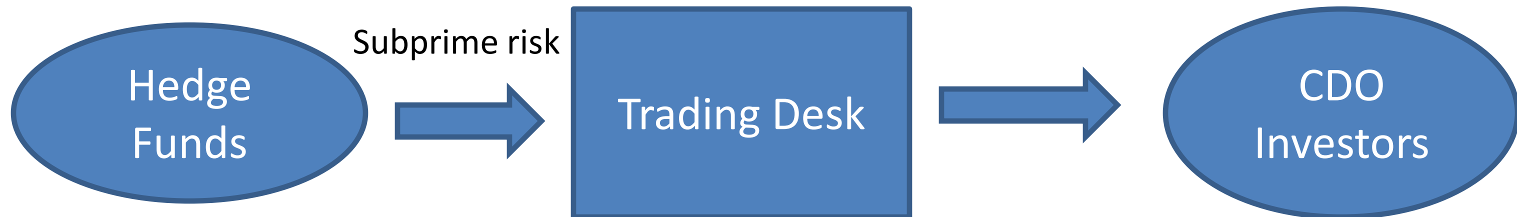
- Credit spread arbitrage
  - Use a credit rating model to justify paying a lower return to CDO investors than market prices indicate
  - Lock in trading profit with SPV / CDS contracts
  - Looks like private-placement underwriting
- Correlation trading
  - Pay tranched credit portfolio risk to investors via derivative or synthetic CDO
  - Buy senior protection from monoline, retain equity risk
  - Dynamically hedge portfolio with single-name CDS
  - Proprietary trading profit from correlation model
  - Looks like market-making

Derivatives Made Underwriting and Market-Making Interchangeable

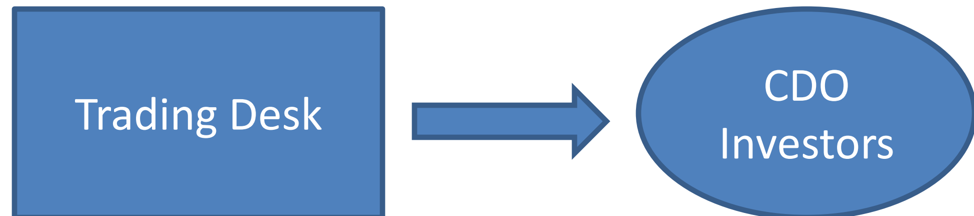
- Traditional Bond Underwriting
  - Acquire warehouse of assets, repackage them
  - The danger is that the underwriter chokes on its own product that it can’t sell when markets turn sour
  - Telecom loans in 2001, Subprime warehouses in 2007
- Credit default swaps transformed this business
  - Investor is now taking a long CDS position
  - Dealer matches them up with a short-seller
  - Use SPVs to turn derivatives into bond investments

Synthetic ABS CDOs 2007 – Hedging or Prop Trading?

- What starts out as a matched position…



- Becomes a prop trade…



- The trade served as a macro hedge for warehoused subprime risk, according to Deutsche & Goldman

Exemptions to Be Wary Of

- Securities Lending
  - AIG's global investment group managed assets for life entities
  - The group lent out securities, and reinvested cash collateral in asset-backed securities; additional returns were not paid to AIG policyholders
  - In 2007, lent securities were returned due to liquidity needs of counterparties, but AIG couldn't sell ABS at par, and needed to make policyholders whole
  - In 2008, Fed had to bail out AIG and take ownership of ABS in Maiden Lane II

Exemptions to Be Wary Of #2

- Repo
  - "exclusions proposed repo positions operate in economic substance as a secured loan, and are not based on expected/anticipated events in asset pricing" (Volcker Rule NPR)
  - MF Global used repo-to-maturity to execute an arbitrage trade in 2011 that it couldn't support, leading to bankruptcy

Exemptions to Be Wary Of #3

- Exchange-Traded Fund Liquidity Provision