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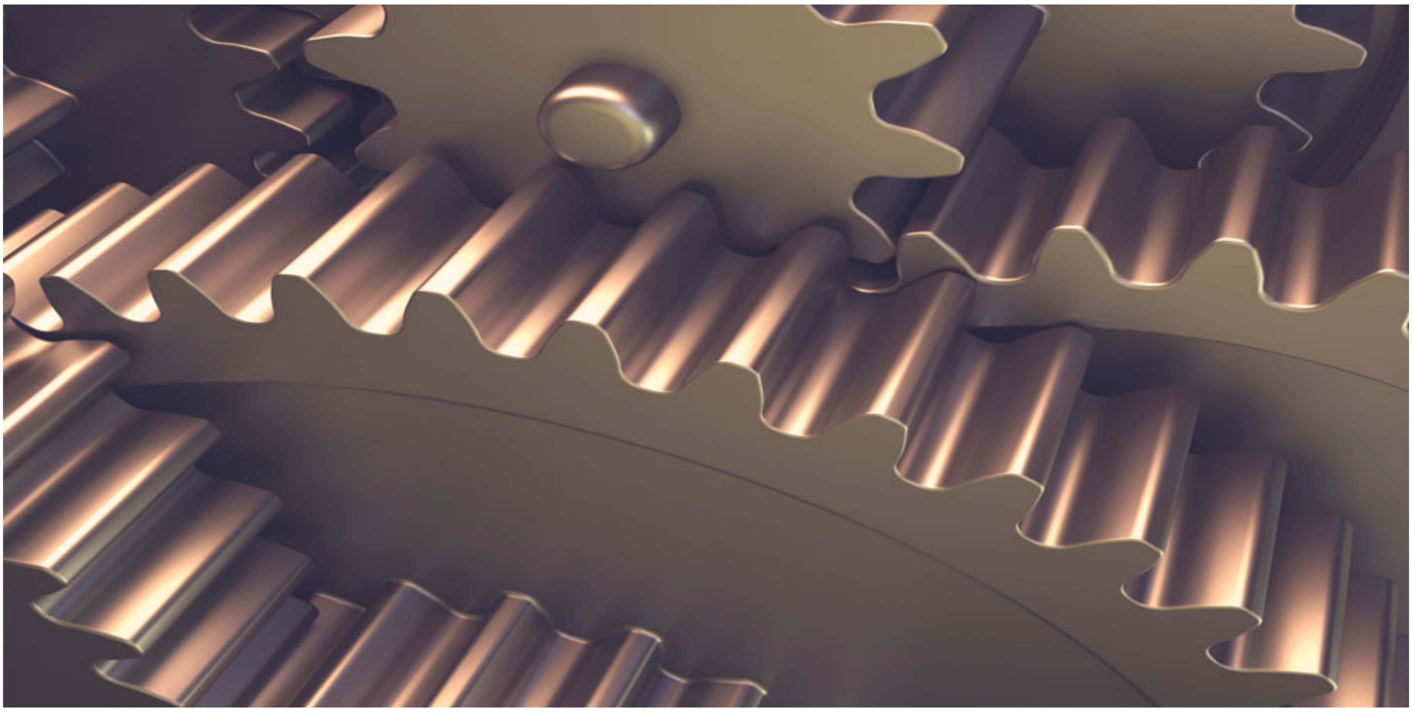

Why This Disruption Is Different—the Volcker Rule

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Along with monetary policy and rules-based strategies, a primary concern for us is the role played by the Volcker Rule—the capstone of the financial industry regulations that came out of the 2008 financial crisis—which changed the dynamics of the markets for the worse.

The Volcker Rule actually first came into force in July 2015 as part of the Dodd-Frank Act. Dodd-Frank added a long list of new regulatory agencies, which imposed a mountain of complicated rules that prompted financial institutions to boost their compliance departments. Together with the new international Basel III framework, it also imposed stringent capital requirements on financial institutions.

Unintended Consequences

The Volcker Rule, Dodd-Frank, and Basel III are all aimed at reducing risk-taking and speculation by financial institutions. Alas, the law of unintended consequences is catching up with these rules faster than most analysts would have predicted.

Essentially, the Volcker Rule restricts proprietary trading by investment banks, which has affected traditional sellside participation in providing market liquidity.

During the 2008 crisis, several years before the rule came into force, the Fed mandated all the large investment banks to have access to the Fed's discount window as a way to prop up the financial system.[1] With this "privilege" came the Volcker Rule that subsequently prohibited their proprietary trading, so as not to "gamble" with the Fed's money.

The Volcker Rule keeps getting revised, and one cannot fault banks for being confused about how to abide by it. As the rule now stands, a trading desk can only hold securities that meet the "reasonably expected near-term demand," or RENTD, of their clients.

This sets limits on a security's exposure, risk, and the time it may be held by the traders. Too long and it looks too much like proprietary trading. While nobody knows how to measure this "reasonable" demand, consultancies are having a field day offering their advice.

Liquidity Concerns

The problem with this approach is that holding an inventory of assets that may be demanded in the future is an important role of market makers. Precluded from serving this function, investment banks cannot be counted on to provide liquidity during a crisis like they have in the past. The Volcker Rule may be preventing large financial institutions from acting as market makers when this is needed the most.[2]

A staff report from the New York Federal Reserve finds that the banks hardest hit by the Volcker Rule are providing much less liquidity than before the rule was enacted, which indicates that the law is having an impact.[3]

A working paper from Fed's Board of Governors draws similar conclusions and also notes that while institutions not covered by the rule have stepped in to take on a bigger role, this has not been enough to prevent an overall drop in market liquidity.[4]

Since the Volcker Rule, the bond market has become paper thin. Despite a reasonable amount of trading volume, dealer corporate bond inventories have declined from $250 billion before the financial crisis to about $30 billion today.[5]

This suggests that a severe absence of liquidity in underlying bonds would greet any forced selling of credit exchange-traded notes (ETNs), especially high-yield vehicles. Credit assets simply do not trade with the same liquidity as their respective listed ETNs. They are not stocks and do not have the liquidity of stocks.

The one area where the Volcker Rule may not pose a problem is in U.S. government, agency, state, and municipal debt, as well as foreign exchange (FX) trading, as these are all exempted. It seems the government wanted to make sure not to hurt its own lending ability with the new regulations.

No Stress Test

In the absence of any serious crash since the Volcker Rule came into effect, any backward-looking analysis can look at changes in liquidity only under relatively normal market conditions. Our worry, though, is that in times of stress, this rule will show its real capacity to stifle liquidity and price discovery.

While many banks have lost the incentive and ability to provide liquidity, many intermediary functions are now handled by high-frequency traders (HFTs), or algorithmic traders.

This is worrying as HFTs will hardly provide liquidity in the face of chaotic markets. They act in sub-second time frames, exploiting system discrepancies and short-term trading behavior quirks.

As Goldman Sachs recently spun Oscar Wilde's definition of a cynic, "HFTs know the price of everything and the value of nothing."[6] It is simply not in their nature to lean against momentum.

Beyond HFTs, hedge funds and other dynamic investors could provide liquidity in due time. We continue to work to position our strategies to avoid illiquidity risk exposures and enable the provision of liquidity when the short-term backstops are contravened.

[1] Dealbook. "As Goldman and Morgan Shift, a Wall St. Era Ends." September 21, 2008.

[2] Duffie, Darrell. "Market Making Under the Proposed Volcker Rule." *Rock Center for Corporate Governance at Stanford University Working Paper* 106 (2012).

[3] Adrian, Tobias, Fleming, Michael, Shachar. Or, and Vogt, Erik. "Market Liquidity after the Financial Crisis." *Federal Reserve Bank of New York Staff Reports*. 796 (October 2016): 11.

[4] Bao, Jack, O'Hara, Maureen, and Zhou, Alex. "The Volcker Rule and Market-Making in Times of Stress." *Finance and Economics Discussion Series* 2016-102. Washington: Board of Governors of the Federal Reserve System (2016).

[5] McAlvany, David, and Orrick, Kevin. "The Bond Market Is Losing Its Biggest Customer in World History." *McAlvany Weekly Commentary*. May 15, 2018.

[6] Goldman Sachs. "Liquidity as the New Leverage: Will Machines Amplify the Next Downturn?" *Economics Research.* May 22, 2018.

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