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Japan and Canada warn on Volcker rule impact

By Tom Braithwaite and Michael Mackenzie in New York, Ben McLannahan in Tokyo and Shahien Nasiripour in Washington (Financial Times)

Foreign governments and asset managers are mounting a last-ditch push against the US Volcker Rule, worried that the proposed ban on proprietary trading could exacerbate a liquidity crunch.

Japanese and Canadian regulators have warned the US government that the rule, which is due to be finalised within weeks and put into force in July, could harm world markets by preventing or deterring US banks such as Goldman Sachs from trading.

The Volcker Rule is designed to prohibit most “prop trading” by banks, where institutions take positions for their own accounts, but Wall Street has argued that the restrictions will also hamper “market making”, where a bank stands between a buyer and seller of securities.

Jun Mizuguchi, assistant commissioner for international affairs at Japan’s Financial Services Agency, said: “We are afraid that US financial institutions may refrain from trading” Japanese government bonds. In a letter to US regulators, the Canadian Office of the Superintendent of Financial Institutions said the rule could “undermine the liquidity of government debt markets outside of the US”.

European bankers and traders have sounded similar warnings about the potential effect of the Volcker Rule on the \$13tn eurozone government debt market. They argue that prop trading provides much needed liquidity and forcing US banks to pull out would cut demand and add strains to the already stressed market.

Next week Fidelity, AllianceBernstein and TIAA-CREF are due to voice their concern at a congressional hearing, according to participants and congressional aides. The asset managers are widely believed to hold more sway with regulators than the Wall Street banks which have an obvious vested interest. AllianceBernstein has warned in a letter of a “devastating effect” on fixed-income market liquidity.

Dennis Kelleher, head of Better Markets, which lobbies for tougher financial regulation, said: “This is just another part of Wall Street campaigning to do whatever they can do to make sure that their most lucrative activities are not regulated. There’s zero evidence that there will be a reduction in liquidity as a result of the application of the Volcker Rule.”

Concern in Japan has mounted after the BoJ first instinctively welcomed the idea, with Kiyohiko Nishimura, deputy governor of the BoJ, saying it would encourage banks to “return to their traditional stronghold of commercial banking business”. “I cannot help feeling that this rule is quite congenial to the traditional Japanese, and probably Asian, view of what banks are.”

The arguments to soften the proposed rule, named after former Federal Reserve chairman Paul Volcker, come during a drop in volumes in US markets that is already concerning some investors and bankers.

US dealer holdings of corporate bonds have fallen to their lowest level since 2002 according to the most weekly recent data published by the Federal Reserve Bank of New York. There has also been a drop in mortgage securities held by dealers to about \$73bn from a recent high of \$89bn in August. Dealers have also been cutting their inventory of long-dated Treasury bonds, since holdings peaked in October.

Dealers say they have been reducing their standard trading amounts in derivatives markets as they and their clients, such as big pension funds, focus on tighter capital and risk-taking rules.

David Felsenthal, partner at Clifford Chance said: “The Volcker Rule has very extensive requirements for reporting and compliance to show that banks are not engaging in proprietary trading. There is a high level of concern around compliance.”

A senior banker said the unintended consequences of restrictions on proprietary trading would fan the rise of “shadow market-making”, whereby less-regulated firms such as hedge funds and asset managers start providing two-way prices across markets. Such players, however, have less capital than big banks and are more likely to walk away from trading when conditions become too volatile.

That raises the spectre of more fragile markets in the future and the potential for a non-bank running into serious trouble that could pose systemic risk to the overall financial system, argues the banker.

The proposed rule was unveiled in October but contained hundreds of questions for public comment, highlighting the difficulties regulators have had in agreeing the details. The Commodity Futures Trading Commission on Wednesday planned to approve its version of the rule, the latest in the complex series of inter-agency procedures.

The two Republican CFTC commissioners said they opposed the proposal: Jill Sommers, in a sharp dissent, said the CFTC’s version of the text was “virtually identical” to that offered by other agencies “well after they have been widely criticised and after many have called for those agencies to start over”.

She added that the proposed measure is “convoluted” and “likely unworkable.” Scott O’Malia, the second Republican, said the agency had “little to no means to enforce – and to deter violations of – the rule”.

Additional reporting by Dan McCrum in New York and Brooke Masters in London