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Unintended Consequences – The Common Denominator in Health Care and Financial Reform

Allan D. Grody January 20, 2014

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Both the Affordable Health Care Act (better known as Obamacare) and the Dodd-Frank legislation that enabled the Volker Rule were passed during a 4 ½ month period in 2010 when both houses of congress and the White House were controlled by one party. Back then, when I roamed the halls of Congress with our "Fix the Plumbing" amendment, the clarion call of the reformers was, 'Just let's pass the damn thing – we'll fix it later!'

Well, now is later and at the detail level, things are failing. The politest comment now heard about Obama Care is that we are in a transformational period of unknown consequences. There is a similar foreboding of the implementation of the Volker Rule. It has not even gotten to the implementation starting gate while having even more significant technology issues to deal with then Obamacare.

Corporations and commercial enterprises are now faced with the fact that a significant weight is being placed on their shoulders to fund Obamacare's ambitions. Similarly, but more subtly this too is the case with the Volker Rule. Basically the rule, named after former Fed chairman Paul Volker, prohibits banks from "proprietary trading," meaning transactions done purely for their own gain, rather than those that serve clients.

The final version of this rule, according to The Economist, is 963 pages, and 2,826 footnotes as well as 1,347 questions, all of which is meant for public guidance. The result will be higher dealer market making spreads, higher capital raising costs, more collateral to backstop risk management contracts, and more fees to replace displaced proprietary bank trading income are looming for industrial users of markets.

Preventing another financial meltdown is, of course, everyone's concern. In the 2007-2008 financial crises from which we are just emerging, the business community and its stakeholders were particularly disenfranchised. Revolving lines of credit were curtailed, businesses couldn't get new loans from banks, public companies were neither able to raise capital nor issue commercial paper, and business users of hedging markets were asked to put up huge amounts of additional cash collateral.

The linkage of Wall Street and Main Street was prominently on display in the recent financial crisis as well. The anxiety of frozen credit markets was equally shared with individuals as well as institutions. Individual and commercial mortgage lending was frozen. Home values dropped below their remaining mortgage values, leaving many homeowners with negative equity in their homes. Default rates soared.

Technology Drives Implementations

While the complications of the Obamacare fiasco has reached all Americans, the complications of the Volker Rule are similarly 'problematic,' but not understood enough to touch the lives of everyday people… yet.

Implementation of Obamacare is, after all just a matter of 'plumbing,' the backend 'stuff, 'primarily the technology of health care reform left as an afterthought that will actually power its website, its backend systems, the payments to insurers and the actual enrollments.

Similarly, in financial reform, eliminating profitable but risky self-trading by banks, and regulating market making and hedging, the three principle components of Volker, requires significant technology implementations. It requires first-time separation of many embedded processes of banks and new automated procedures to eliminate risk. It also requires regulators to have the policing power to enforce these new regulations, if they can observe these violations in the first place.

The Volker Rule will impose new demands on financial institutions and their commercial clients i.e. not exceeding customer near term historical trading patterns; estimating client future trading demands; explaining trades that heighten compliance risk; calculating correlations of each hedged trade, etc. This will also require regulators to develop the technology tools to monitor the effects of the rule while continuing to allow the American economy to function smoothly. The volume is too huge and the speed of trading too fast to expect any of this oversight to be done manually, a technological feat yet to be implemented.

Impact on Corporations and Commercial Firms

Market making, the use of a bank's capital to facilitate customer trades, is the bedrock of institutional markets that trade in less liquid financial instruments and contracts. Such common money market instruments as commercial paper, treasury bills and notes, short term credit instruments, securitized loans, etc. and longer term corporate, municipal and government debt are inventoried by banks for availability (the supply side) and then sold to commercial customers as their cash flow, investment needs, and risk management interests surface (the demand side). Volker rules demand an accounting of client facilitation purpose vs. proprietary trading for the banks own account.

Making such determinations will come down to implementations in technology. Without definitive automated audit trails showing timing of each transaction, prior historical trading trends, risk mitigating trades that correlate with banks hedging strategies exclusively for the benefit of clients, etc. an army of lawyers will be required to resolve subjective interpretations of regulators asserting Volker rule violations.

To understand the implementation burden, recall that the financial system is a 'system', an almost indescribable interconnected web of computers and networks. Financial institutions are huge technology factories. They have survived within a crumbling underfunded infrastructure and a Rube Goldberg legacy of technology each financial institution lives with day to day.

We have already exceeded the capacity of the "system" to absorb more incremental change, now even more so due to regulatory overreach. We see this dysfunction every day: in market shutdowns, stolen credit card portfolios, failed IPOs, swaps trades that overwhelm regulators' computer capacity, false starts on electronic trade audit trails, inability to aggregate data for systemic risk analysis across multiple financial institutions, inability to aggregate risk data for each financial institution across business silos, etc. And let us not forget the frauds perpetrated by CEOs and traders alike, and the collusion on a massive scale from the artificially wide dealer spreads on NASDAQ stocks of the 1990's, to the most recent Libor rate fixing scandal and insider trading convictions.

The Volker Rule, in anticipating implementation issues has caveated many of its reforms by saying that they might not work for specific trading desks or asset classes. In fact, the portfolio hedging strategy that was at the root of JPMorgan Chase's whale trading disaster, and that was one of the two prominent issues that propelled Volker's passage, was punted to the banks under a vague notion of having the banks prove it is a specific hedge not a portfolio hedge.

Passing framework rules and leaving procedural and technology implementation as an afterthought has proven disastrous in other areas of financial reform. Most notably in derivatives reform the regulators are overwhelmed with volumes of newly required faulty swaps data because data identification standards and formats were not prescribed first. Neither did the systems undergo formal integration testing, a similar problem that surfaced with Obama Care.

Volker and Beyond

The scope of new monitoring systems that would have to be put in place at trading desks is undetermined, yet the rule requires a host of risk calculations based on historical trading data, correlation patterns, and stochastic probability measures. It should be noted that that such calculations proved inadequate in the past to predict risk. Witness the calamity of the financial crisis that engulfed lenders and borrowers, capital users and providers, and commercial paper issuers and purchasers when these same risk measures were relied on in the past.

Under Volker, banks remain largely responsible for their own compliance. The key drivers of enforcement are "written policies and procedures" and "internal controls." JPMorgan Chase's extensive pre-Volcker written policies and controls were of little use in averting the $6 billion trading loss. Could these same tools prevent another such loss in the post-Volcker era?

The final rule requires "independent" testing of a bank's hedging strategies by consultants or auditors. It looks to us like regulators are punting their legislated oversight role to others, conceding that they do not have the tools to monitor the very rules they are prescribing. Actually without new technology, both at the banks and at the regulators, this oversight will be left wanting. Recall the checklist mind set of regulators that left the Madoff Ponzi scheme undetected.

Unintended Consequences

Surely, commercial and institutional users of capital markets and risk-shifting contract markets will see spreads widen, more cash collateral required and banking fees increase. More worry though is the potential of regulators to again fail to observe the buildup of risk in the financial system even though so many new rules have been written. For without an ability to observe banks' financial transactions as they occur and accumulate risk in near real-time, the regulators will be unable to see that which they have been mandated to oversee.

Lest we again suffer the lesson of unintended consequences, best we stop checking off nonsensical boxes that attest to 'I completed' this or that regulation. It only signifies the rule was written. Instead, we need to check off the 'I implemented the solution and it is working' box. That is where the rubber hits the road.

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