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Statement of the Shadow Financial Regulatory Committee

Recent Financial Stability Oversight Council's Reports on Risk Retention and Proprietary Trading

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The Financial Stability Oversight Council (FSOC) recently released two studies as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The first study deals with the so-called Volcker Rule. The rule severely restricts banking entities from engaging in proprietary trading and investing in or sponsoring hedge funds and private equity funds. The second study examines the macroeconomic effects associated with the Act's requirement that securitizers and originators of asset-backed securities retain no less than 5 percent of the credit risk imbedded in the securities they issue. Both reports are thoughtful and provide comprehensive discussions of the practical issues and considerations in implementing the requirements and set forth principles that should guide the responsible regulatory agencies in promulgating regulations to implement the statute's applicable provisions. Missing, however, are the specifics about how the agencies, when they write the required rules, are to address the problems the FSOC has identified.

The Committee is concerned that the specific plans adopted could unintentionally and significantly affect the size and efficient operation of financial institutions (from the prohibition on proprietary trading) and asset-backed securities markets (from the risk retention rules). For example, the requirement that originators of asset-backed securities retain at least a portion of the risk, depending upon how that is defined, could significantly impact the riskiness of the securities that are issued and the scale of issuer activities. Depending upon how accounting conventions treat the risk retention requirements,

institutions may be forced to recognize securitizations on their balance sheets and increase the amount of capital that they are required to hold. The IMF's Global Financial Stability Report of October 2009 shows that setting the level of risk retention to properly incentivize issuers is a complex problem. In the case of low-quality securitizations, risk retention requirements of the most risky equity tranche may actually reduce incentives for monitoring and risk control rather than increase those incentives. Some have proposed requiring multiple levels of risk retention by various parties to a securitization. This may simply reduce the volume of such issues to the extent that the markets may cease to function, despite the intention. Finally, the FSOC suggests that institutions should not be permitted to hedge their exposures to the risk they retain through their securitizations. Since institutions often manage their risk exposures on a consolidated basis and not transaction by transaction, it may be virtually impossible to determine whether securitization positions are or are not being hedged.

Many of these same problems also arise in the case of the Volcker Rule restrictions. The report properly considers the difficulties in identifying proprietary trading and when particular hedging and other related transactions may or may not be construed as proprietary trading. The issues are especially complex with respect to hedging. Large institutions often manage risk on a consolidated dated basis, and may do so through their trading or in other books of business. Because of the regulatory uncertainties many institutions are already reorganizing their proprietary trading activities into separate affiliates or subsidiaries which will not ameliorate the problems noted with respect to hedging. Many are exiting the business in anticipation of pending regulations of that activity.

In summary, while the FSOC has met the requirements of the Dodd-Frank Act to prepare reports, the Council, like the Congress has deferred to the responsible regulatory agencies to do the heavy lifting when it comes to balancing the competing concerns that arise in promulgating the regulations to implement the Act.