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THE VOLCKER RULE’S HEDGING EXEMPTION

Spencer A. Winters*

The comment period for the proposed regulations to be promulgated under the Volcker Rule expired on February 13, 2012.1 The rulemakers received over 16,000 comments during that period, in what one commentator described as a “fecal storm.”2 Though that description is hopefully an exaggeration, it is safe to say that the Rule’s implementation has been contentious. The Volcker Rule, named for former chairman of the Federal Reserve Paul Volcker, is a component of the Dodd-Frank Act,3 which Congress passed in response to the recent financial crisis. The Rule’s statutory provision charges the nation’s financial regulators with issuing a body of regulations that expand upon the statutory provision.4 The rulemakers have issued a set of proposed regulations,5 which were meant to go into effect no later than July 21, 2012 but were overdue as of the publication of this Essay.6

The Rule’s statutory provision entails a simple prohibition on proprietary trading, followed by a definition of proprietary trading and a long list of exemptions. It states plainly that a banking entity7 (which I will simply call a “bank”) “shall not . . . engage in proprietary trading.”8 It then defines

* J.D. Candidate, May 2013. I would like to thank Andrew Hartlage, Professor Hwa-Jin Kim, Sarah Palmer, Joanna Rogow, and my parents.

5. Id.
7. “Banking entity” is defined broadly to include not only insured depository institutions but also bank holding companies and their subsidiaries. See 12 U.S.C. § 1851(h)(1) (2006).
8. Id. § 1851(a)(1)(A). The statutory provision also states that “a banking entity shall not . . . acquire or retain a hedge fund or a private equity fund.” Id. § 1851(a)(1)(B).
proprietary trading as transacting in securities or derivatives for the purpose of benefiting from short-term price movements.9

Of the Rule’s laundry list of exemptions,10 this Essay will focus on the hedging exemption. The hedging exemption allows banking entities to engage in proprietary trading for the purpose of undertaking “[r]isk-mitigating hedging activities in connection with and related to individual or aggregated positions . . . designed to reduce the specific risks to the bank in connection with and related to such positions.”11 On its face, the hedging exemption allows a bank to bypass the Volcker Rule if the bank is adopting a given proprietary position in order to reduce a specific risk associated with another of the bank’s positions.

The proposed regulations significantly expand upon the statutory provision. They provide for a rebuttable presumption that a position held by a bank for sixty days or less is a proprietary trade.12 A bank could rebut this presumption by demonstrating that it did not take the position principally for purposes proscribed by the Volcker Rule, namely benefitting from short-term price movements.13 Even a short-term trade designed to hedge another short-term trade would trigger this presumption, and the fact that it was motivated by risk reduction would not rebut the presumption.14

It may seem peculiar that the proposed regulations proscribe taking positions for the purpose of hedging. However, the fact that the statutory provision contains a hedging exemption at all indicates that Congress meant that positions taken for the purpose of hedging other short-term positions should qualify as prima facie proprietary trades. Such a position will then only be exempt if it meets the specific requirements of the hedging exemption.

The proposed regulations provide a set of requirements under which a particular proprietary trade would qualify as an exempt hedge. In addition to certain procedural requirements,16 the hedging exemption under the proposed regulations has three substantive requirements. First, the proprietary trade must mitigate “one or more specific risks,” including market risk, credit risk, counterparty risk, currency risk, interest rate risk, or basis risk.17 Second, the proprietary trade must be “reasonably correlated” to that specifi-
ic risk.\textsuperscript{18} Third, at the “inception of the hedge,” the proprietary trade must “not give rise . . . to significant exposures that were not already present . . . and that are not hedged contemporaneously.”\textsuperscript{19} I call this final requirement the “no-new-risks” requirement.

In this Essay, I briefly discuss potential applications of the Volcker Rule’s hedging exemption. In Part I, I make note of the fact that many hedges put on by banking entities will not be “proprietary trades” in the first instance because they will be long-term hedges. Although these long-term hedges need not rely on the hedging exemption to be lawful, short-term hedges must. In Part II, I argue that the no-new-risks requirement, if read literally, would render the hedging exemption inert because all hedges create new risks. In Part III, I propose a simple fix to the no-new-risks requirement that either the rulemakers should incorporate into the regulations before promulgation or that decisionmakers should read into the regulations after promulgation.

I. SHORT VS. LONG-TERM HEDGES

Many of the hedges that banking entities enter into—namely, long-term hedges—will not be prohibited by the Volcker Rule in the first instance and thus will not need to meet the three requirements of the hedging exemption. Imagine a federally insured depository institution that enters into a five-year fixed-for-floating rate swap, a transaction designed to reduce the bank’s exposure to interest rate risk over the next five years. Interest rate risk refers to the possibility of a reduction in gross interest income due to a change in market interest rates.\textsuperscript{20} The most acute source of interest rate risk is the practice of taking short-term deposits and making long-term loans, which is called “mismatching maturities.”\textsuperscript{21}

Banking entities can hedge interest rate risk with a derivative security called a fixed-for-floating rate interest rate swap,\textsuperscript{22} also known as a plain vanilla swap. In this context, a plain vanilla swap is a contract whereby the bank agrees with a counterparty to pay a fixed rate of interest in exchange for a floating rate of interest.\textsuperscript{23} By trading a fixed rate for a floating rate, a bank can reduce its exposure to interest rate risk because the transaction reverses the maturity mismatch that created the interest rate risk in the first place.

It might be tempting to begin applying the three hedging exemption requirements to this transaction, but doing so is unnecessary because this hedge is long-term in design and thus is not a prohibited proprietary trade. A position is only a prohibited proprietary trade if the bank uses it in an

\textsuperscript{18} Id. § 5(b)(2)(iii), 76 Fed. Reg. at 68,948.
\textsuperscript{19} Id. § 5(b)(2)(iv), 76 Fed. Reg. at 68,948.
\textsuperscript{20} JOËL BESSIS, RISK MANAGEMENT IN BANKING 85 (3d ed. 2010).
\textsuperscript{21} Id. at 84–85.
\textsuperscript{22} Id. at 92–93.
\textsuperscript{23} See id.
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attempt to profit from short-term price movements or to hedge short-term price movements.24 Assuming this five-year swap is not closed out within sixty days, it will likely avoid regulatory scrutiny all together. However, even if the trade is closed within sixty days—say, because the bank’s view on future interest rates changes—the bank can rebut the sixty-day presumption by showing that, at the outset, the transaction was long-term in design. The same principles apply to shield other types of long-term hedges from the Volcker Rule’s prohibition, like long-term hedges against credit risk using credit default swaps.

Of course, interest rate swaps, credit default swaps, and other derivative securities are not necessarily useless for short-term hedging. For example, credit default swaps might be used to hedge against market-making activities in bonds and other fixed-income securities. In the event that a bank does use these derivatives in this fashion, it might well run into the new risks problem discussed in the next Part.

II. THE FLAW IN THE NO-NEW-RISKS REQUIREMENT

This Part argues that, taken literally, the no-new-risks requirement of the hedging exemption will render the exemption inert. Consider a bank that uses put options to hedge its market-making securities inventory against market risk. Market risk refers to the possibility of trading losses due to a change in the prevailing price of a given asset.25 Market making26 is one activity that can expose a bank to market risk.27 A risk banking entities can hedge using a derivative called a put option.28 A put option is a contract that gives the holder the right but not the obligation to sell an asset at some time in the future at a price agreed upon today.29 The agreed-upon price at which the holder can sell the asset is called the exercise price or the strike price.30 A bank can thus use a put option as insurance against a price drop because the put locks in a selling price for the bank. The bank buys and sells puts, often in the same trading day, to maintain a consistent level of insurance against market risk.


28. See BESSIS, supra note 20, at 75.

29. Id. at 70; see also Fischer Black & Myron Scholes, The Pricing of Options and Corporate Liabilities, 81 J. POL. ECON. 637, 637 (1973).

By way of example, consider a bank that is a market maker in Microsoft stock. The bank takes a $300 million position in Microsoft stock at the opening bell, buying 10 million shares for $30 each. As insurance against a decline in the value of this $300 million in inventory, the bank can purchase 10 million put options on Microsoft stock struck at $30 and expiring in 30 days. This gives the bank the right but not the obligation to sell 10 million shares of Microsoft stock to the option counterparty for $300 million at any time in the next 30 days. Thus, if bad news breaks about Microsoft, and the shares drop by $2 each, causing a $20 million loss on the bank’s position, the bank can sell the shares to its counterparty for $300 million, thus avoiding the loss.\footnote{In the real world, the option seller would not actually buy the stock from the bank (which is called “taking delivery”). Instead, the option seller would simply pay the bank the $20 million by which the asset price is below the strike price. BESSIS, supra note 21, at 70.} Of course, this insurance comes at a cost to the bank, the cost of buying the put option in the first place—say $1 per option or $10 million in total.\footnote{This was the approximate price of thirty day near-the-money puts on Microsoft stocks on March 2, 2012, when Microsoft shares were trading at around $32 per share. See Microsoft Corp. (MSFT) Options, YAHOO! FINANCE, http://finance.yahoo.com/q/op?s=MSFT+Options (last visited Mar. 2, 2012).}

Because the bank buys and sells the puts within a sixty-day period, the transactions would trigger the rebuttable presumption under the proposed regulations. The bank would not be able to rebut this presumption because the trades were designed to hedge short-term risks: the short-term market risk associated with market making.\footnote{Market making is itself an activity exempt from the prohibition on proprietary trading. 12 U.S.C. § 1851(d)(1)(B) (Supp. IV 2010). There is thus the distinct possibility that trades designed to mitigate market-making activities would fall under the market-making exemption in addition to the hedging exemption. See id. (exempting “market-making-related activities” (emphasis added)). The market-making exemption is outside the scope of this Essay. However, one can readily conceive of a hedging scenario that does not involve an otherwise exempt activity. I use the market-making example because I believe it is relatively easy to understand.}

Thus, assuming neither the market-making exemption nor any other exemption applies, the bank will be forced to invoke the hedging exemption. Again, under the proposed regulations, the hedging exemption would have three requirements: that the trade hedge a specific risk, that it be reasonably correlated thereto, and that it not create new risks. The proposed regulations specifically list “market risk” as an example of a specific risk, so this trade easily meets the first requirement.\footnote{Prohibitions on Proprietary Trading § .5(b)(2)(ii), 76 Fed. Reg. at 68,948.} Second, assuming the put options reference the specific asset in the bank’s market-making inventory, the positions should have near perfect correlation, thus satisfying the second requirement. However, the third requirement—that the hedge create no new risks—is problematic. The proposed regulations specifically provide that, to qualify for the hedging exemption, a given proprietary trade must “not give rise, at the inception of the hedge, to significant exposures that were not already present in the individual or aggregated positions, contracts, or other holdings...
of a covered banking entity and that are not hedged contemporaneously.”

However, hedges invariably give rise to at least one new risk: counterparty risk, namely the risk that the hedging counterparty defaults on its obligation. Thus, taken literally, the no-new-risks requirement could render this exemption useless.

The proposed regulations’ allowance of new risks if they are “hedged contemporaneously” would appear at first blush to be a potential solution to the new risks problem. If we take as true the proposition that all hedges give rise to new risks, this allowance simply creates a circularity problem. True, the bank could hedge the risk that its option counterparty defaults by purchasing insurance against that risk. Yet purchasing insurance exposes the bank to new counterparty risk: the risk that the insurer defaults. Insuring against insurer default poses the risk that the secondary insurer defaults. And so on.

Another potential solution that likewise fails to bear fruit is the fact that the no-new-risks requirement only prohibits “significant” new risks. The risks of hedging are far from insignificant. For example, the liquidity risk associated with margin calls on derivatives can cause severe financial distress. Likewise, for an example of counterparty risk wreaking havoc on venerable institutions, one need look no further than the financial crisis, wherein AIG nearly defaulted on billions of dollars of credit default swaps before receiving a government bailout.

III. A SOLUTION TO THE FLAW

The rulemakers could best solve the new risks problem by amending the regulations before promulgation. The simple fix to the problem would be to change the language of the third requirement to something along the lines of: the proprietary trade “does not give rise, at the inception of the hedge, to significant exposures that were not already present . . . and that are not hedged contemporaneously, other than those risks inherently a part of hedging.”

However, even if the rulemakers do not make this fix, the above is a plausible reading of the Volcker Rule as it stands. The second requirement that the proposed regulations put on the hedging exemption, the requirement that the trade be reasonably correlated to the position it is meant to hedge, supports this reading. The second requirement is a restriction on a specific type of risk: the risk that a position designed as a hedge does not perfectly

35. Id. § .5(b)(2)(iv), 76 Fed. Reg. at 68,948.
36. BESSIS, supra note 21, at 28–30;
37. E.g., SATYA JIT DAS, TRADERS, GUNS & MONEY 96 (2006) (recounting a $1 billion margin call precipitated by an otherwise well-designed hedge, which caused severe financial distress to the hedger).
offset the position it is meant to hedge, which is called basis risk. The second requirement, in not requiring perfect correlation of risks, allows the bank to assume a reasonable quantum of basis risk when it puts on a hedge. If the third requirement, the no-new-risks requirement, were construed to prohibit the assumption of any new risks, then the second requirement’s partial restriction on the assumption of basis risk would be superfluous. Therefore, even if the rulemakers do not fix the no-new-risks requirement before promulgation, those in a position to interpret this provision should read it as permitting risks inherent in hedging.

CONCLUSION

The Volcker Rule prohibits banking entities from entering into transactions in order to benefit from short-term price movements but provides an exemption for transactions designed to hedge existing risks. Many hedging transactions will not need to rely on the hedging exemption in order to avoid the Volcker Rule’s prohibition because they will be long-term trades. Those that are short-term in nature, however, may encounter a problem with the Volcker Rule’s proposed regulations that stems from their requirement that an exempt hedge create no new risks. The simple solution is to read the no-new-risks requirement so as not to apply to those risks inherent in hedging, like counterparty risk and basis risk.