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SNL NASHVILLE NOTES

Wednesday, August 30, 2017 6:00 AM CT

Conspiracy theories

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence or Mercer Capital, where he is the managing director of the financial institutions group.

The Financial Times had a fantastic piece on Aug. 22 about the lobbying efforts of Goldman Sachs Group Inc. to water down the Volcker rule, which prohibits prop trading and certain types of investments by regulated banks. The article also noted Goldman alums Gary Cohn and Steven Mnuchin are in positions to influence policy as respective heads of the National Economic Council and Department of the Treasury. Cohn seems to be the favorite — and a good pick, in my perhaps ill-informed view — to replace Janet Yellen as the Chairman of the Board of Governors of the Federal Reserve System.

Goldman is not referred to as Government Sachs without reason. Some conspiracy theories have a grain of truth. This may be one, but in saying so I do not mean to disparage the public service Messrs. Cohn, Mnuchin and other Goldman executives who have served over the years.

Goldman is an easy target for Washington and Wall Street competitors to take potshots. What was the once-undisputed leader of Wall Street has been humbled by the financial crisis that included ascension (or devolution) in 2008 to a bank holding company regulated by the Fed. The 2010 Dodd-Frank Act included the Volcker rule, which has limited Goldman's and other banks' trading revenues. Whether calculated or just a cruel irony, the Volcker rule is particularly problematic for Goldman because it has the least diversified business model among the major U.S. banks. Trading, investment banking and asset management are the primary revenues, not traditional banking. Goldman Sachs Bank USA posted net income of $387 million (about 1.0% ROA) in the quarter ended June 30, compared to $1.8 billion by the consolidated company.

And Goldman's second-quarter results were panned by investors, largely because of a weak quarter for fixed income — technically fixed-income, currencies and commodities (FICC). S&P Global Market Intelligence noted 11 of 13 banks it tracked reported double-digit percentage declines in second-quarter FICC revenues from a year ago, while FICC revenues at Goldman fell 40%. Subsequent reports attribute part of the outsized drop to bad energy trades and a customer mix that is heavily reliant on hedge funds, which are, as a group, not exactly thriving in recent years. Nonetheless, no one should be surprised that Goldman is attempting to influence modifications to the Volcker rule that would advantage it and competitors.

I am sympathetic to Goldman's and other banks' efforts to loosen the Volcker rule not so that Goldman, JPMorgan Chase & Co., Citigroup Inc. and the like can make more money, but because liquidity is the lifeblood of markets. After initially shrugging off any impact on liquidity or suggesting the impact of Volcker was minor, it seems as though the Fed has come around to the view that the rule has come at a cost. Traders I know and see quoted in the media on the subject mostly pan what has happened to liquidity since the Volcker rule was adopted — especially in the fixed income markets.

Market making at the "banks" — actually within the securities units — still occurs in the context of executing customer order flow, but inventories of corporate bonds and other securities have been cut dramatically. The inventory that may have been acquired for prop trading or from a longer-term view of meeting customer order flow pre-Volcker now resides elsewhere. Does that matter? Maybe not so much in our current low volatility world but it could. Whenever markets become turbulent again the market making support the large banks provide will be limited. Falling markets can sometimes cascade into a panic, and trouble usually develops in the more important credit markets than before equity markets face trouble. The prevalence of liquid ETFs in which the underlying assets such as corporate bonds are illiquid may prove to be the equivalent of dousing a forest fire with gasoline.

Long since forgotten is the bang-up FICC quarters Goldman and JPMorgan posted in the first quarter of 2009 when market-making and prop trading benefited from liquidity provided to an illiquid market. Goldman posted $6.6 billion of FICC revenues that quarter, 34% higher than its previous record and over 5x the $1.2 billion reported last quarter. JPMorgan reported $4.9 billion of fixed income revenues then compared to $3.2 billion last quarter.

Yes it is self-serving for Goldman to make a push to loosen the Volcker rule, but no one should be surprised that Paul Volcker's straight-forward proposition that banks should not be in the business of prop trading (i.e. Goldman's old money making business of moving assets) has been codified in over 950 pages of bureaucracy. I am no expert on prop/principal trading vs. agency trading but I do not think there is much conspiracy in an effort to loosen the interpretation of the Volcker rule and improve market liquidity even if Goldman makes a little bit more money because of it.

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Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.