☎ 617.237.6111 ✉ info@databoiler.com databoiler.com

Treasury Got a "D"

*By **Kelvin To**, Founder and President of Data Boiler Technologies*

The U.S. Treasury published a report on June 12, 2017 in respond to the President's Executive Order (EO) 13772 on core principles for regulating the U.S. financial system. It has an interesting remark about the design and implementation of the Volcker Rule: "far overshot the mark" – a vague compliment or false-modesty. However, the report itself scored low marks and I am giving it a "D" grade because:

- Off topic, incomplete, failed to provide a macro view to help facilitate actions.
- Totally missed the mark on discovering ways to cope with 21st century challenges.
- Omitted a roadmap of how supervisory changes will translate into economic benefits.

The EO explicitly asks for "the extent to which existing laws/ policies promote and support the President's core principles", whilst the report included fluffs on "why" alignment is importance. The President doesn't need the Treasury to endorse these principles. Instead, the report is expected to be an independent assessment about the existing financial regulatory environment, so the President may use it to form basis for his own ideas on what changes need to be made. Sadly, the proposition of this report seems skewed with 97 recommendations stuffed in appendix B. It's like hijacking the President's agenda/ action plan rather than facilitation!

To sensibly facilitate changes that the President wants to achieve, the report ought to showcase a big picture and illustrate where the missing pieces are. In particular, President Trump would be interested in avoiding policy mistakes of his predecessors and getting ready to cope with 21st century challenges. Thus, the report should include:

(i) Historical crises/ destabilizing factors that could have been prevented by today's policy tools and technologies;
(ii) Descriptions of the 21st century financial market challenges (e.g. abusive use of financial engineering and speed);
(iii) Gaps to be filled despite the many improvements (e.g. removal of stub quotes, market access rule 15c3-5, limit up/ limit down and circuit breakers updates, Reg. SCI, etc.)

Unfortunately, the report confines its scope to just blemish Dodd-Frank's burden on depository system, when EO clearly asks for a comprehensive review of "all" regulatory regimes within 120 days. Treasury Secretary Steve Mnuchin only turned-in ¼ of the assignment by not covering the other sectors and failed to analyze matters holistically. No way can anyone give this report more than a "D" grade when it is incomplete!

It leaves out many crucial components, such as Reg. NMS market structure rule, SEC 613 consolidated audit trail project, treaties and impacts of EU's MiFID II, etc. Therefore, the President cannot reasonably rely on this report to holistically set priorities for things he wants to get change. There are so much that the Treasury and FSOC could have helped the President to discover ways to modernize market surveillance, reform Freddie and Fannie, etc. In fact, the only thing pertains to modernization in this report is about the Community Reinvestment Act, yet no concrete plan is available!

Placing myself into the shoes of Gary Cohn (the President's Chief Economic Advisor), I'll be so disappointed to see this report, which lacks a clear roadmap of how the reduction in banks' regulatory burden would translate into meaningful

☏ 617.237.6111 ✉ info@databoiler.com databoiler.com

economic growth. There has long been question whether modern society still rely much on banks for financing, given the increase significance of the shadow banking sectors (see this). Regardless of such, the report missed the mark because the following details are not available:

(a) Estimate growth in banks' small business and consumers lending amid competition with non-bank lenders;
(b) Expected increase and timing to pick up on syndicate loans, infrastructure and other project financing;
(c) Quantify liquidity improvement through banks' sponsorship* of hedge funds and private equities;
(d) Any plan to revitalize merchant banking/ commodity markets while ensure risks won't be re-introduced;
(e) Banks versus other market makers (include HFT) in provision of liquidity during both good and bad times;
(f) Downside – if banks repurchase own shares when there lack profitable liquidity outlets, or divest internationally.

* Note, the Volcker Rule currently set a 3% limit on sponsorship of covered funds. The President and his legal counsel do not need this treasury report to remind them 35 out of 97 recommendations require congressional approval (a hurdle hard to overcome in helping the near-term economics).

Besides, it won't be as easy as in the past to revitalize market for illiquid assets. Consider junk bonds that need credit enhancement to sweeten the deal to attract buyers. However, the buy-side remains skeptical with these toxic assets because mortgage back securities with AAA credit rating can go busted during the 2008 crisis. Thus, don't blame the rule for causing adverse selection of certain asset class, the fragmented liquidity issue could well be like a hoax of Dihydrogen Monoxide ban (see this).

Amid the supportive low interest rate environment for an extended period, economy is not picking up as fast as one wish. Partially it's because the old economic model driven by high consumer spending and lending is no longer working (see this). More importantly, the problem is attributed to the government and congress failed to recognize that policy actions alone won't be enough to facilitate economic growth. Modern era calls for:

Adopt new ways of thinking and identify enabling technologies that will spur economic opportunities.

Take the Volcker Rule covered fund requirements for example. OCC Acting Comptroller Keith Noreika has stated in a WSJ interview that he wants to "ensure risk from affiliates doesn't come back to haunt banks". It'll be heavy lifting or impossible task to manually determine whether or not a secondary trading instrument is or is not a covered fund (see this). Alternatively, if we can look into the asset gathering and fund distribution processes, and use behavioral science to ensure "exit only, no re-entry" – like "letting go" of bad habits/ toxic assets, then we can make the financial markets safer while less burdensome to the industry. The point here is: to enable distinct advantages of the U.S. markets over other foreign countries; I believe innovation is the only way to drive sustainable economic growth!

Last but not least, I advocate for the removal of 79 FR 5592 - Footnote 711 instead of requesting banks to submit unnecessary metric reports for the Volcker Rule proprietary trading ban requirements. Play-by-play instrument approach to securities inventory/ RENTD is crucially important to address financial engineering abuses and cope with market timing issues. No one should forget the many painful lessons since the downfall of Barings. Policy-makers ought to take strong stand to curb against speculative risks that have repeatedly brought the economy down to its knees. Again, this illustrates why the report needs a holistic review across depository system, the capital markets and other sectors. Therefore, the treasury report only deserves a "D" because of its incompleteness.

*** END ***