FINANCIAL TIMES

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November 21, 2011 9:33 pm

US bankers warn reforms will hit eurozone

By Brooke Masters and David Oakley in London

A view of Wall Street from the steps of Federal Hall in lower Manhattan

New curbs for US banks that restrict their ability to trade with their own capital will hit liquidity and demand for eurozone government bond markets at a time when both are in short supply, bankers have warned as they prepare to lobby regulators to water down the rules.

The Volcker rule, passed as part of the Dodd-Frank reform package, will ban proprietary trading by all US banks starting in July 2012. Since the draft regulations came out last month, bankers have been warning that it would hit liquidity from equities to corporate bonds.

But eurozone sovereign bonds have raised particular concerns because US banks have historically played an important role in a market that has seen flows dry up because of worries over spiralling debt and the health of economies such as Italy.

Bankers and traders say that "prop" trading – trading on banks' own accounts – is a big part of the US presence in the $13,000bn eurozone debt market, but exact figures are hard to come by.

"We provide a lot of liquidity to the system. If we are not able to take positions for our own books, then clearly that is going to hit liquidity. We are a big player in the eurozone government bond market," said a proprietary trader at one US bank in London.

"With Basel rules [for bank capital globally] and other regulations, it is another impediment to the market that could hit liquidity and the overall health of the market."

Regulators are so far not convinced that the rules need to be modified. They point out that US banks can continue to buy and sell eurozone sovereigns for market-making purposes and for their required stocks of liquid assets. They also say that US banks can continue to buy and hold sovereigns as long-term investments and that European banks are unaffected by the rules as long as they keep their trading outside of the US.

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But industry participants on both sides of the Atlantic fear the Volcker rule as drafted will hit hard at overall demand.

"What came out in this proposal is a fairly draconian interpretation of the law. If it is finalised without changes, it is very likely that

Congress's wide-ranging reform of Wall Street under the Dodd-Frank legislation and Mary Schapiro's internal revolution at the SEC have ushered in an era of more stringent regulation in the US

banks would do less trading and it will be more expensive for their clients," said Kathy Dick, partner at Promontory consultancy.

They point out that Dodd-Frank exempts US sovereign bonds from the general prop trading ban for fear of disruptions. "What happens if you remove the US banks from Europe and they dump the stuff? Prices could collapse," said Doug Landy, a regulatory lawyer at Allen & Overy.

Industry lobbyists are still preparing the industry's case for submission. They are trying to decide whether to lobby for an exemption or seek a broader definition of liquidity and market making that would encompass more trading.

"This is an issue that has come up and we are looking at it," said Robert Toomey, managing director at Sifma, the securities industry lobbying group.