



Volcker inventory: too complicated or just unfamiliar?

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You may get thrown out of a casino for allegedly counting cards. However, bankers may be considered guilty if they do not count inventory under the Volcker Rule. The Rule is bizarre to ask banks to come up with “reasonable” expected near-term demand (RENTD) forecast. It sounds **absurdly complicated to determine “reasonable” demand**. Let’s discuss appropriate and inappropriate ways to account for reasonable activities under Volcker regime.

Some banks are quick to equate “risk appetite statement” (RAS) to the Volcker’s RENTD forecast. RAS is typically written as a **static document at a board level** stating the “X” percent chance of “Y” dollar amount of losses that the bank is willing to take in pursuing their business objective. To some extent, the magnitude of percentage and dollars reflect the aggressiveness of the bank in the market. In fact, RAS, which is part of the “Enterprise Risk Management” (ERM) governance concept, is only relevant to Volcker in context of setting tone and assuring risk culture and to conduct improvements. It **misses the dynamic aspect of a forecast to consider the markets and clients from time to time**.

Demand can be lower than the firm’s risk appetite, which makes the securities inventory plan unrealistic/ unreasonable.

A true demand forecast should perform scenario planning for **the right amount of trades at the right time**. This is not the same as risk tolerance levels under different stress situations for ERM. ERM risk tolerance limits are often set based on a firm’s risk capacity and historical experience. Actually, history is almost always wrong in predicting the future, especially for the event-driven equity market. Therefore, analysts preparing RENTD need to look at order imbalances, market dynamics, and other event-driven factors on a daily basis. They have to keep count and mark-off what’s available in inventory against the upcoming customers and counterparties’ demand at different time; project it onto a time horizon and optimize the time to replenish inventory. **The timing to get in or out of a position is critical to determine “reasonableness” of trade activities**.

Think about a gambler doubling down his/her bet after every loss. Huge losses can be accumulated within a few hands when luck continues to go the opposite direction. The same is true when rogue traders pretend to hedge their trades by bumping-up intra-day basis risk while keeping delta risk in place. The X% chance of maximum loss probability calculated by daily **Value-at-Risk (VaR) would never be able to cope with impending problems happening in a split second**, as in the London Whale case. This gambling practice is, in essence, proprietary trading which is a serious violation of the Rule.



Also, Volcker’s “instrument approach” to inventory is **different from risk limits**. Trading desks need to constrain traders from using any instruments they like. Treasury desk should not be short-selling, underwriting desk should not use over-the-counter derivatives, hedges shouldn’t be selling credit-default swaps, etc. Instruments are supposed to be **tightly managed under a white list, black list, detection engine** (lists of permissible/ prohibited/ hard to distinguish trades activities), and other rigorous controls to prevent rogue traders from synthetically creating trades that may otherwise be prohibited.

Furthermore, a detection engine needs to incorporate an **ABC analysis** (an inventory categorization technique commonly used in retail/manufacturing) to measure the frequent use of instruments and venues. This may scrutinize infrequent trade instruments and/or venues, but former Fed Chairman Paul Volcker once said in a CNBC interview “if people wanted to trade odd-ball securities... market risk is part of that.” To him and other government officials, they are not concerned about liquidity in government/ agency bond market because these instruments are on the white list of permissible activities. Banks need justification for those outlier instruments (e.g. infrequently trade TruPS with turnover >60 days) to ensure related market risks are deemed reasonable; we have the algorithms to help.

Banks asked if the regulators can provide a definitive/ step-by-step guide to Volcker compliance. At the same time, banks do not want the regulators to use one “generic” template to measure the effectiveness of a bank’s RENTD in comparison to others. Here is how a vendor solution can help.

1. Banks simply pick a combination of market scenarios, client types/segments, and instruments;
2. Provide the vendor a set of assumptions, risk management policy, liquidity plan, etc. that are unique to the firm;
3. Calculator(s) crunches out customized RENTD forecast for each trading desk on a daily basis.

The advantages of using an independent vendor’s algorithm are: (a) the validity has already been proven; (b) parameters are customizable to ensure fit-for-purpose; (c) it saves time and costs to deal with nuances in daily reforecast. Banks should not reinvent the wheel when all the research has been done and the algorithm has patent pending protection. Embracing the “instrument approach” to inventory is inevitable for the Volcker rule compliance. It is also a necessity to upgrade related risk management controls to deal with intraday “doubling down” risky bets.

Imagine the capital market as a giant casino. Banks assume the role to prevent rogue traders from circumventing controls, while allowing reasonable activities to be permissible. Don’t blame the regulators for introducing this harsh rule, because today’s rogue traders are getting smarter and legacy controls (VaR and/or risk limits) are easy to bypass.