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US Banks, Competitive Advantage, and the Volcker Rule

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“Essentially, JPMorgan has been operating a hedge fund with federally insured deposits within a bank.”

Mark Williams, Federal Reserve bank examiner and Boston University finance professor

“If you don’t have a competitive advantage, don’t compete.”

Jack Welch, former CEO of GE

This paper applies standard strategic competitive analysis (Porter 1979, 1980, 2008) to two activities of taxpayer-guaranteed banks, business lending and proprietary trading. It finds that banks have a strong competitive advantage at business lending and a strong competitive disadvantage at proprietary trading. Thus in addition to protecting taxpayers and nonfinancial businesses, the Volcker rule also prevents banks from competing in an activity at which they have a competitive disadvantage. The paper also dissects JPMorgan’s (JPM) “London Whale” speculation of 2011-2012 as an example of banks’ competitive disadvantage at proprietary trading.

Porter strategic competitive analysis

Strategic competitive analysis applies at the level of a specific line of business. Thus a firm may have a competitive advantage in some product lines but not in others. There are five dimensions on which a firm’s managers should assess the attractiveness of continuing in or entering a particular line of business, indicated immediately below with some prominent indicators for each dimension.

The threat of new competition considers the possibility that effective new suppliers will enter the market. Pertinent factors include the existence of barriers to entry, product differentiation, brand equity, customer loyalty to established brands, and capital requirements.

The threat of substitute products or services addresses whether the existing product line could be subverted by a new product. What are the relative prices of the new substitute and the established product? Is it easy or difficult, costly or expensive, for customers to abandon your product? How much, if any, product differentiation do customers perceive?

Customer bargaining power relates to the relative degree to which a firm and its customers can set the terms of purchases, including price, quantity, quality, service, and other product attributes. Considerations include buyer switching costs, information availability, availability of substitutes, buyer price sensitivity, and the uniqueness of the supplier's product.

Supplier bargaining power relates to the relative degree to which a firm and its suppliers and employees can set the terms of their interactions in the business-to-business and labor markets. How costly is it for suppliers and employees to move on to other customers or employers? How sensitive are the firm's total costs to agreements with suppliers and employees? Are substitute inputs available, including contracting out some salary and wage costs? What is the degree of employee solidarity?

Intensity of competitive rivalry in the business line assesses competitive advantage/disadvantage relative to existing competitors. Does the firm have a sustainable competitive advantage through innovation? Is online business a threat and, if so, is the firm well represented online? What are the levels of advertising effort? Does some other factor give the firm or a competitor a powerful competitive advantage, such as geography, control of an important input, de facto industry standards, or the like?

A Porter analysis of the competitive advantage of banks in business lending and proprietary trading

Taxpayer-guaranteed banks engage in a number of product lines, especially the largest banks, those once regarded as "too big to fail" (TBTF). One product line is a traditional business for banks on which they have severely reduced their participation since early in the financial crisis, namely **business lending to nonfinancial firms**. In the view of many economists, banks have slashed credit offerings to existing and potential loan customers, even those with strong business performance. Otherwise healthy firms deprived of commercial lending that had been available for decades have no choice but to cut inventories, production, and employment. In this analysis, the financial crisis spilled over to the real economy, significantly deepening and extending the recession that began in December 2007. Business lending encompasses not just financial underwriting analysis, but also relationship banking and workout expertise.

A more recently adopted business line for some but not all large taxpayer-guaranteed banks is **proprietary trading**, formerly the exclusive province of sophisticated wealthy individuals and hedge funds. A timely example is JPM's "London Whale" trade, analyzed at the end of this paper. Although "hedge" funds openly engage in proprietary trading, it most often represents

blatant **speculation**, a conscious expansion of risk exposure in pursuit of higher returns. **Hedging** is the opposite of speculation, namely the reduction of risk exposure, usually but not always at the expense of expected return. (A farmer and a miller on opposite sides of grain futures contracts both reduce risk, leaving expected return unaffected aside from transactions costs.)

The next five subsections assess taxpayer-guaranteed banks' competitive advantages and disadvantages on the five strategic dimensions of Porter analysis. Each contains a summary table. Ratings in the second and third columns of the table refer to whether each factor tends to give banks a competitive advantage or not. *Yes* and *No*, respectively indicate factors that foster competitive advantage or do not. *Some* means that a partial tendency to competitive advantage exists. In particular, *Yes* and *No* do not indicate that banks exhibit that factor to a high or low degree. For example, in the table assessing competitive advantage against substitutes, *Yes* on *Ease and cost of switching* registers that switching lenders is costly and difficult, not easy and cheap, and thus confers a competitive advantage on banks. Finally, *Bus lend* and *Spec trade* are abbreviations for business lending and proprietary, speculative trading.

Bank advantage, new competition

	Bus lend	Spec trade	Notes on speculative trading
Entry barriers	Some	No	New hedge funds start up weekly
Product differences	Some	No	Only returns matter
Brand equity	Yes	No	Only returns matter
Customer loyalty	Yes	No	Only returns matter
Capital	Yes	No	Initially \$10 million suffices

New hedge funds enter the business of speculative, proprietary trading every week, often with only a few million dollars of partner's money. In contrast, rankings of volume of business lending differ little today from a decade ago. Personal relationships are an important part of successful business lending, serving to reduce information asymmetries and transactions costs. Clients judge hedge funds and other speculative investment managers solely by returns or, rarely, by returns relative to risk. Indeed, a paradox exists. A public firm whose earnings are characterized by volatility suffers a discount on its price-earnings (PE) multiple compared to comparable firms with more stable earnings.

Bank advantage, substitutes

	Bus lend	Spec trade	Notes on speculative trading
Relative prices	Some	No	High employee costs
Ease and cost of switching	Yes	No	Investors are already diversified
Perceived differentiation	Yes	No	Only returns matter

Threats from substitutes represent a particularly challenging competitive disadvantage for banks in proprietary trading. Banks' salary structures do not accommodate the high compensation levels earned by top traders at hedge funds. Investors seeking speculative hedge fund exposure and achieve it more efficiently by buying hedge fund units. Most investors seeking hedge fund exposures are already well diversified and will perceive little differentiation in have a bank take on such exposures.

Bank advantage, customer power

	Bus lend	Spec trade	Notes on speculative trading
Switching costs	Yes	No	Investors are already diversified
Information availability	Yes	Yes	Lax disclosure requirements
Substitutes available	Some	No	There are thousands of hedge funds
Price sensitivity	Yes	No	Only returns matter
Uniqueness	Some	No	Strategies are easily copied

Commercial loan customers are much less likely to desert a bank that suffers a difficult time, compared to investors making exit decisions after poor proprietary trading results. For a nonfinancial firm to duplicate a relationship with a new lender is time consuming and fraught with uncertainty. Switching to a different speculative investment manager, in contrast, encounters few impediments. Investors seeking speculative exposures might be thought to understand the risks involved. They nevertheless prove surprisingly fickle after a couple of quarters of large losses.

Bank advantage, supplier power

	Bus lend	Spec trade	Notes on speculative trading
Supplier/employee switching cost	No	No	Repo lenders deal with many borrowers; top traders lured away
Inputs and costs	Yes	No	Sophisticated repo lenders; compensation a major cost
Substitute inputs	No	No	Cannot replace repo investors, employees with specific skills
Employee solidarity	Yes	Yes	Unlikely union setting

Financial services is a knowledge industry in which human capital is the most valuable asset. Human capital moves across firms with much lower transaction costs than physical capital. This is true both for speculative investment traders and for business loan officers. The sole exception may be that superior business lending officers may find it difficult to take clients with them when leaving a firm. This means that a lending banker changing employment may have to suffer a couple of years recruiting new business loan customers before achieving her/his previous level of compensation.

Bank advantage, competitive rivalry

	Bus lend	Spec trade	Notes on speculative trading
Innovation advantage	Some	No	Hedge funds are more nimble
Online versus offline	Yes	Yes	Online unrealistic
Advertising expense	Yes	No	Only returns matter
Powerful strategy	Some	No	Only returns matter

Taxpayer-guaranteed banks engaged in speculative trading have no competitive advantage against hedge funds and other non-bank rivals. Advertising and corporate strategy cannot help in a returns-driven service. Further, hedge funds have proved themselves far more nimble in innovation of new products, strategies, and analyses. In contrast, for business lending, banks have a clear or partial advantage in innovation, productive advertising, and corporate strategy.

Summary, competitive advantage of banks in business lending and proprietary trading

	Business lending			Speculative trading		
	Yes	Some	No	Yes	Some	No
New competition	3	2	0	0	0	5
Substitutes	2	1	0	0	0	3
Customer power	3	2	0	1	0	4
Supplier power	2	0	2	1	0	3
Competitive rivalry	2	2	0	1	0	3
Total	12	7	2	3	0	18

The table above tabulates the number of factors in the five dimensions of competitive analysis that tend to give banks have a clear competitive advantage (Yes), some advantage (Some), and a competitive disadvantage (No) in business lending and in proprietary trading.

The usefulness of competitive analysis such as Porter's is that it requires an analyst to be specific about business line competitive advantages and disadvantages on important elements over all dimensions of competitive threat. Lacking such discipline, the analysis risks becoming impressionistic and ungrounded.

A careful analysis of the characteristics under which taxpayer-guaranteed banks participate in the activities of business lending and proprietary trading makes it clear that banks have a strong competitive advantage in lending and a notable disadvantage in speculative trading.

There is no other conclusion but that implementing the Volcker rule would prevent banks from engaging in an activity for which they have a competitive disadvantage. This result reinforces the initial motivation for the Volcker rule, namely to protect taxpayers and nonfinancial businesses, both of whom have suffered at the hands of the banking system during the financial crisis that began in 2008. Banks reduced or eliminated credit indiscriminately, starving even long-standing business customers, including those that had never missed a payment. A nonfinancial firm that cannot finance its inventories and accounts receivable has only one choice, to reduce inventory, output, and employment. This scenario was replayed again and again.

JPMorgan's "London Whale" speculation

JPM's loss of as much as \$9 billion in its "London Whale" speculation during 2012 provides a crystalline example of the comparative disadvantages of

banks in speculative trading and of the threat to taxpayers who are ultimately at risk.

In 2007, JPM reported \$76.5 billion of investment securities. By 2011 investment securities had more than quadrupled to \$356.0 billion, much resulting from JPM's merger with WaMu (formerly Washington Mutual, a very large savings bank). A considerable portion of the new investment securities was of low quality. At some point a decision was taken to reduce risk exposure. In 2011 JPM bought credit protection in the CDX IG Series 9 and related CDO tranches. This index was launched in 2007. By 2011 it was four years old and thinly traded. Its remaining contract length provided protection for another year or less. The most effective hedge, of course, would have been to sell some of the WaMu securities.

Due to the small volume of trading in the four-year-old CDX IG Series 9 securities, JPM's purchases drove up the price and generally caused the cost of protection to rise. Reportedly JPM then recorded gains on its existing positions.

By late 2011 and early 2012 JPM apparently sold credit protection in longer dated CDX IG indices and CDO tranches. JPM called this action a "hedge of a hedge," but it is not. It is a speculation that economic crises, including Greece and the euro, would be resolved in less than one year. The most effective way to reduce a hedge is to take offsetting positions in the same instruments. By March 2012, JPM gross positions in CDX IG indices and tranches exceeded \$1 trillion.

In May 2012 JPM announced a \$2 billion loss to date and the likelihood of further losses on its CDX IG-related positions. Within a few days JPM revised the loss estimate upward to \$3 billion. In June 2012 press reports indicated that JPM insiders confirmed that the estimated ultimate loss was about \$8 billion to \$9 billion and that this had been known sometime in May.

In releasing its second quarter 2012 earnings, JPM reported a quarterly loss of \$4.4 billion on the London Whale speculation. It also reported a first quarter 2012 loss of \$1.4 billion, necessitating a restatement of earnings for the period. Separately, JPM announced that it had liquidated about half of the \$1 trillion-plus gross positions by July. This surprised some market participants, because forcing large one-sided volumes very rapidly through markets often exacerbates realized losses, causing prices to move against the strategy.

A common misapprehension about hedged positions in corporate debt

A hedged position in a business loan or a corporate bond is economically equivalent to a **synthetic Treasury bond (T bond)**, due to no-arbitrage pricing. The investor earns only the default-free rate on a T bond, but earns no risk premium for exposure to credit risk.

In contrast, a bank that has a competitive advantage in business lending can earn an **excess return above T bonds**, even if it manages its credit risk exposure with credit default swaps (CDS). The source of the excess return is the bank's competitive advantage in maintaining client relationships, proprietary knowledge of the loan customer and its industry and geographic location, underwriting expertise, and workout experience.

Conclusions

A standard strategic competitive analysis (Porter 1979, 1980, 2008) demonstrates that taxpayer-guaranteed banks possess a competitive advantage in business lending, but confront a serious competitive disadvantage in proprietary trading. This result provides an additional rationale for the Volcker rule, quite apart from shielding taxpayers from speculative trading losses and protecting nonfinancial firms from credit crises. An analysis of JPMorgan's London Whale losses, possibly as much as \$8 billion to \$9 billion, provides a clear example. Finally a common misapprehension about CDS-hedged positions in corporate bonds and in business loans is refuted. A portfolio of a corporate bond and CDS protection is economically equivalent to a synthetic T bond. The expected return equals the riskfree rate. But banks with a competitive advantage in business lending can earn more than the riskfree rate while minimizing their credit risk.

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