

Why GAO Did This Study

In addition to trading on behalf of customers, banks and their affiliates have conducted proprietary trading, using their own funds to profit from short-term price changes in asset markets. To restrain risk-taking and reduce the potential for federal support for banking entities, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the act) prohibits banking entities from engaging in certain proprietary trading. It also restricts investments in hedge funds, which actively trade in securities and other financial contracts, and private equity funds, which use debt financing to invest in companies or other less-liquid assets. Regulators must implement these restrictions by October 2011. As required by Section 989 of the act, GAO reviewed (1) what is known about the risks associated with such activities and the potential effects of the restrictions and (2) how regulators oversee such activities. To conduct this work, GAO reviewed the trading and fund investment activities of the largest U.S. bank holding companies and collected selected data on their profits, losses, and risk measures. GAO also reviewed regulators' examinations and other materials related to the oversight of the largest bank holding companies.

What GAO Recommends

As part of implementing the new restrictions, regulators should collect and review more comprehensive information on the nature and volume of activities potentially covered by the act. Treasury and the financial regulators agreed to consider this as part of their rulemaking.

View [GAO-11-529](#) or key components. For more information, contact Orice Williams Brown at (202) 512-8678 or williams@gao.gov.

PROPRIETARY TRADING

Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented

What GAO Found

Proprietary trading and investments in hedge funds and private equity funds, like other trading and investment activities, provide banking entities with revenue but also create the potential for losses. Banking entities have conducted proprietary trading at stand-alone proprietary-trading desks but also have conducted such trading elsewhere within their firms. GAO determined that collecting information on activities other than at stand-alone proprietary trading desks was not feasible because the firms did not separately maintain records on such activities. As a result, GAO did not analyze data on broader proprietary trading activity but analyzed data on stand-alone proprietary-trading desks at the six largest U.S. bank holding companies from June 2006 through December 2010. Compared to these firms' overall revenues, their stand-alone proprietary trading generally produced small revenues in most quarters and some larger losses during the financial crisis. In 13 quarters during this period, stand-alone proprietary trading produced revenues of \$15.6 billion—3.1 percent or less of the firms' combined quarterly revenues from all activities. But in five quarters during the financial crisis, these firms lost a combined \$15.8 billion from stand-alone proprietary trading—resulting in an overall loss from such activities over the 4.5 year period of about \$221 million. However, one of the six firms was responsible for both the largest quarterly revenue at any single firm of \$1.2 billion and two of the largest single-firm quarterly losses of \$8.7 billion and \$1.9 billion. These firms' hedge and private equity fund investments also experienced small revenues in most quarters but somewhat larger losses during the crisis compared to total firm revenues.

Losses from these firms' other activities, which include lending activities and other activities that could potentially be defined as proprietary trading, affected their overall net incomes more during this period than stand-alone proprietary trading and fund investments. Some market participants and observers were concerned that the act's restrictions could negatively affect U.S. financial institutions by reducing their income diversification and ability to compete with foreign institutions and reducing liquidity in asset markets. However, with little evidence existing on these effects, the likelihood of these potential outcomes was unclear, and others argued that removing the risks of these activities benefits banking entities and the U.S. financial system.

Financial regulators have struggled in the past to effectively oversee bank holding companies. While the act's restrictions reduce the scope of activities regulators must monitor, implementing them poses challenges, including how to best ensure that firms do not take prohibited proprietary positions while conducting their permitted customer-trading activities. Regulators have yet to gather comprehensive information on the extent, revenues, and risk levels associated with activities that will potentially be covered, which would help them assess whether expected changes in firms' revenues and risk levels have occurred. Without such data, regulators will not know the full scope of such activities outside of stand-alone proprietary trading desks and may be less able to ensure that the firms have taken sufficient steps to curtail restricted activity.