Traders Are Just Being Traders (But That's No Excuse)

By Martin Hutchinson *Wed, Jul 18, 2012*

"Trading is a largely instinctive activity, strongly related to the amount of testosterone in the body," writes Martin Hutchinson, our occasional guest columnist.

The bankruptcy of the broker Peregrine Financial this week, with $200 million in customer accounts gone walkies, adds to the Barclays Libor scandal in increasing the general public public's horror of the financial services business.

However as scandal succeeds scandal and loss succeeds loss, one common thread becomes apparent: the scandals and losses are almost entirely contained in the trading arms of the institutions concerned. This should cause us to focus on traders, their activities, motivations and ethics, and ask whether such an extreme reliance on trading is essential to the financial service business's health.

Trader/neurobiologist John Coates in *The Hour Between Dog and Wolf* [has set] out recent discoveries on the biology of trading behavior. The biology is complex and interesting, but the bottom line is that trading is a largely instinctive activity, strongly related to the amount of testosterone in the body. Coates shows that high-testosterone traders both take greater risks and achieve larger rewards, assuming their personal earnings are linked to trading success.

Many high-testosterone traders will achieve excellent returns, but in bubble markets there will be a tendency for them to overtrade and lose amounts of money that are large both in relation to their potential profits and, if there are any "holes" in their employer's risk management, in terms of the employer's balance sheet as a whole.

Is trading a sport?

Trading is a rapid-motion activity, akin to many athletic endeavors—a fact of which Coates is inordinately proud—the thought that he is the equivalent of a star athlete is no doubt a consolation during those interminable hours in the gym. Of course, the activity also appears to be akin to other skilled and fast-reaction activities such as driving a truck, an altogether less glamorous comparison.

There's no question: the banking system needs traders, as do stock exchanges. Liquidity is a vital attribute of financial assets; without it we would be reduced to the level of 16th century Venetians, borrowing money from Shylock to fund a small number of "ventures" which could all be wiped out by ill-timed storms or piracy.

The invention of London's coffee houses, and the ability they gave investors to get in and out of both small and large positions in debt and equity, was an important civilizational advance, without which capital would be far more expensive, business formation much more difficult and a modern diverse, fast-moving economy impossible.

However the secret weakness in the traders' case is made by Coates in his disparaging remarks about traders who make money simply through the flow of sales orders generated by a large financial institution. For Coates, providing liquidity for a $100 million debt or equity order by a major institution is child's play, requiring few if any of the traders' characteristics of which he is so proud. True traders, according to Coates, are those who work unattached to a large institution, making their returns simply by taking positions against the market as a whole.

It is clear that for large institutions, "good traders" can be very dangerous. Risk management systems are fallible, and it is in the interests of the traders collectively to ensure that such systems are not too constricting.

Since it is possible to devise instruments such as collateralized debt obligations (CDOs) and credit default swaps (CDS) in which the risks are much larger than assessed by conventional risk management systems, the temptation is there for traders to take risks that would be unacceptable to the institution's shareholders.

The risk is exacerbated if there is a "too big to fail" system in place; the knowledge that the institution will *in extremis* be bailed out by taxpayers is far too tempting to even the averagely aggressive trader.

Structurally, there is no need for an aggressive trading operation in a "too big to fail" institution, or one that accepts insured deposits. Such institutions need an order execution capability to satisfy the liquidity needs of their clients. But bad, or at least unaggressive traders provide just as much liquidity as good traders—they simply extract smaller "rents" from the markets in trading profits. That's not a problem; if a big bank trading desk has a good flow of institutional business, it will make good money anyway by satisfying the needs of its clients.

Three courses of action

From the standpoint of a regulator who wants to ensure the soundness of the institutions he regulates, there are three courses of action available.

One is a "Volcker Rule" which prohibits proprietary trading—but as we have seen regulators are unable to draft such a rule that does not run to 200 pages and leave far too many loopholes.

A second is the simple one of prohibiting systemically important banks from employing male traders (or females with an unusually high testosterone level). That would ensure that big bank traders were of the vegetable-grazing low-risk type that made money through executing their clients' orders but took only modest risks.

A third alternative would be to prohibit, in systemically important institutions, bonuses of more than 25% of salary or pay rises of more than 25%. Salaries themselves could be large, for those who had remained within the institution for many years and had worked their way up, but their variability would be low.

Hence traders, whose livelihoods would no longer depend on doing more than a professional honest job, would no longer feel a rush of adrenaline during periods of market turbulence. For them, trading would be no more than a video game, albeit one which their employer required them to play competently. Theirs would be an intellectually boring life, but a safe one – exactly what their employers' shareholders and depositors should wish.

With traders in "too big to fail" and deposit-taking institutions neutralized, the risk to taxpayers and markets from those institutions would more or less disappear. Other risky activities, such as underwriting and merger arbitrage, would migrate to smaller institutions with more aggressive pay scales. In other words the system would migrate to something very like the British system before 1986, with the big money in large dozy institutions and the aggressive deal-making in smaller houses.

As for pure trading, that would migrate to hedge funds, which would be risky entities to deal with and hence would be able to employ only moderate leverage. However, limiting the capital available to "good" traders would itself be beneficial; it would limit the rents they could extract while allowing them to provide liquidity and a limited market for pathological-risk products such as CDS and subprime CDOs.

Of course, much of the last generation's move to trading in financial services is now migrating to machine-based systems, which through "fast trading" represent a high percentage of trading volume, but make much of their profit from "insider" information about the market's trade flow.

There is a simple solution to these too; a very small "Tobin tax" on transactions – around 0.01% *ad valorem*, considerably smaller than that currently proposed in France and elsewhere in the EU. The purpose of such a tax would be only incidentally to raise revenue, but to make algorithmic "fast trading" considerably less profitable than it is currently, thus limiting the rent-seeking of the mechanical as well as the human variety of trader.

Coates has done the financial services industry and its customers a great service. By demonstrating the biological basis for pathological trading activity, [Coates] has provided an avenue by which regulators can force such activity out of entities for which they are responsible, and banish it to the fringes of the market.

Of course, while *Bernankeism* remains in vogue at the world's central banks, and interest rates are negative in real terms, fringe operators will find it only too easy to borrow more or less infinite amounts of money, thus bankrupting large portions of the system when they fail, as they inevitably will. However it is hoped that even *Bernankeism* is a temporary, if excessively long-lasting, market aberration.

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