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THE VOLCKER RULE DISTRACTION: There Is a Better Way to Fix "Too Big to Fail"

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Since JPMorgan Chase announced a trading loss of at least $2 billion last week, reporters, analysts, and politicians have focused anew on the Wall Street Reform and Consumer Protection Act. President Obama signed this financial-regulation law, known as Dodd-Frank, into law nearly two years ago, on July 21, 2010.

In the past week, observers have placed most of their attention on Dodd Frank's Section 619: "The Volcker Rule." The Volcker Rule, when it goes into effect as early as July 2012, will prohibit banks such as JPMorgan from engaging in "proprietary trading," or speculation.

In the aftermath of the JPMorgan Chase announcement, the Volcker Rule proponents' position has been as follows. Were the Volcker Rule in place already, the rule would have prevented JPMorgan from engaging in the trading that resulted in the loss, as such trading, they say, was "proprietary." Although details are unclear, JPMorgan appears to have taken its loss in using "excess deposits" to invest in debt securities and attempt to hedge those investments. ("Excess deposits" are the difference between the amount of money a bank has taken in from depositors and the amount of money it has loaned out to borrowers.) As Sen. Carl Levin

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(D-MI), who helped write the Volcker Rule language, said four days after the bank's announcement, the Volcker Rule would have prohibited such activities: "If this law were in effect when they made these trades, I believe that these trades violated or were inconsistent with Dodd-Frank, yes."[1]

Yet it is far from clear that the Volcker Rule would have prevented JPMorgan from engaging in the activities that led to its loss. Among other things, the Volcker Rule allows banks to engage in securities and derivatives trading to hedge risk, as JPMorgan claims this particular activity was intended to do. Moreover, it is far from clear that preventing financial-industry losses—even losses that lead to financial-firm failure—should be the goal of financial regulation. Instead, the goal should be for financial firms to be able to fail without endangering the broader economy.

Rather than focusing on the Volcker Rule, lawmakers and regulators should turn their attention to improving other aspects of Dodd-Frank so that the law can better achieve its goals of preventing bailouts and protecting the economy from the risk posed by the financial industry.[2] These areas include treatment of derivatives instruments, treatment of capital and other requirements for "systemically important financial institutions," and treatment of failing financial firms via "orderly liquidation authority." Moreover, if lawmakers remained concerned that insured depositories such as JPMorgan should not trade in the securities markets, there is a far more straightforward way for lawmakers to accomplish that goal.

REPEAL THE VOLCKER RULE

Background

The Volcker Rule, a late addition to Dodd-Frank drafts, was the brainchild of Paul Volcker, who served as Federal Reserve chairman under former presidents Jimmy Carter and Ronald Reagan. In early 2010, Volcker went to President Barack Obama with a concern: new financial regulation would not prohibit banks from using deposits that carry taxpayer-backed FDIC guarantees to engage in speculative activities. Volcker considered this a moral hazard—that is, an invitation to banks to take undue risks with other people's money. President Obama agreed. Standing with Volcker that January, he said, "I'm proposing a simple and common-sense reform, which we're calling the 'Volcker Rule'—after this tall guy behind me. Banks will no longer be allowed to own, invest, or sponsor hedge funds, private equity funds, or proprietary trading operations for their own profit, unrelated to serving their customers."[3]

Lawmakers followed Obama's direction. The Dodd-Frank Act amended the Bank Holding Company Act of 1956 to direct regulators to ensure that "a banking entity shall not (A) engage in proprietary trading; or (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund."[4]

Practical Challenge

Regulators have found that while the Volcker Rule seems clear in theory, it is difficult to implement in practice. The practical difficulty is in determining the definition of proprietary trading. Lawmakers made it clear in Dodd-Frank that banks could continue to engage in trading meant to reduce their risk. As the law states, they can conduct "risk-mitigating hedging activities in connection with and related to individual or aggregated positions." The line between speculating and hedging, though, can be a blurry one.

Indeed, in releasing their 209-page draft rule language last October, regulators from the Department of the Treasury, the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve, and other agencies noted that:

> [T]he delineation of what constitutes a prohibited or permitted activity under [the Volcker Rule] often involves subtle distinctions that are

> difficult both to describe comprehensively within regulation and to evaluate in practice. …[A]ny rule must … preserve the ability of a banking entity to continue to structure its businesses and manage its risks in a safe and sound manner, as well as to effectively deliver to its clients the types of financial services that [the rule] expressly protects and permits. These client-oriented financial services, which include underwriting, market making, and traditional asset management services, are important to the U.S. financial markets …[5]

The trouble over defining proprietary trading makes it impossible to know if Levin is correct. Had the Volcker Rule been in place, it might well have prevented JPMorgan from engaging in these transactions. All hinges on whether regulators view such trades as hedges or as speculation. JPMorgan seems to have been using derivatives markets to sell protection against corporate-debt defaults rather than purchase such protection, an important distinction that seems to undermine the bank's hedging claims. As a lender, JPMorgan already faces significant exposure to debt defaults, and so presumably would purchase protection against defaults, rather than take on more risk in this area.

In either case, leaving such judgments up to regulators and bank officials on a case-by-case basis leaves the financial system vulnerable to the risk that such judgments could turn out to be incorrect. Moreover, even hedging activity carries significant risk; banks attempting complicated hedges can find themselves vulnerable to the risk that the institutions with which they have hedged are unable to make their payments when the hedge is most needed. Hedging becomes even riskier and harder to differentiate from speculation when banks attempt to reduce risk broadly, across an entire portfolio, rather than security by security. Yet the law, as enacted, is clear that broad hedging activity—that is, on an "aggregate" basis—is allowed, making regulators' job a tough one.

Furthermore, determining which trades are hedges and which are speculative becomes even more difficult when one considers that the Volcker Rule applies not only to institutions such as JPMorgan Chase, traditionally focused on commercial banking, but also to institutions such as Goldman Sachs and Morgan Stanley. These firms have traditionally focused on investment banking, but they became bank holding companies in the aftermath of Lehman Brothers' collapse. Investment banks often purchase securities in anticipation of customer demand for such securities. Yet it is not clear whether such purchases constitute proprietary trading or market-making.

To take a specific example: In April, the New York branch of the Federal Reserve decided to sell some of the mortgage-related securities it had purchased in 2008 as part of its effort to rescue the insurer AIG. The buyers of the Fed's assets were major investment banks. The banks bought the securities from the Fed because they expected to sell the securities to their own customers and earn a profit. The draft language for the Volcker Rule does not make it clear whether such purchases would violate the provision once it goes into effect.

Safety and soundness

Efforts to define proprietary trading might be worth the cost if the Volcker Rule were to reduce the risk that banks pose to the broader economy. Yet there is no evidence that it will. Before 2008, customers of investment firms such as Bear Stearns, Lehman Brothers, and Goldman Sachs had no recourse to the FDIC. The firms were not bank holding companies, and thus would not have had to conform to the Volcker Rule. Had the Volcker Rule been enacted in 2005, it would not have prevented Lehman Brothers from failure, or prevented Lehman Brothers' failure from spreading panic throughout the rest of the financial system.

Where proprietary traders, hedge funds, and other non-traditional financial companies or affiliates did contribute to the 2008 crisis, they did so by providing short-term demand during the boom years for securities made up of long-term credit instruments such as mortgages. Their trading helped spur demand

for mortgage lending that should not have occurred. And when these investors dumped mortgage-backed and other securities *en masse* starting in 2007, lack of demand helped dry up credit in the economy, precipitating a severe recession. Yet pension funds and overseas investment funds, neither of which will operate under the Volcker Rule's restrictions, also helped to exacerbate such forces. As long as America allows for debt creation through capital markets, this risk will continue to exist whether financial firms provide short-term demand for long-term assets from within banks or from outside of banks.

Another problem with the Volcker Rule is that it sends the wrong message about bailouts. The FDIC, which has recourse to the U.S. Treasury, does not insure banks. The FDIC insures individuals' deposits at banks, up to $250,000. The point of FDIC insurance, then, is not to use taxpayer money to prevent banks from failing. It is to use taxpayer money to aid small savers when banks do fail. Implying, then, as the Volcker Rule does, that banks whose customers enjoy FDIC insurance enjoy protection from the government does not remedy "too big to fail." Such an approach helps extend "too big to fail."

Finally, the Volcker Rule could itself distort financial markets and add risk to them rather than reduce risk. The rule contains exemptions for proprietary trading in U.S. government securities, municipal securities, and securities backed by federally guaranteed mortgages. Such exemptions artificially encourage trading in—and demand for—such securities. The exemptions could encourage banks to concentrate their holdings in just a few areas of the economy, leaving them more vulnerable to mass panics when such economic areas go sour.

Lawmakers should repeal the Volcker Rule so that regulators can direct their attention to better methods to end "too big to fail" and, relatedly, reduce the risk that the financial industry poses to the broader economy. If lawmakers believe that deposit-taking banks should not be in the securities business, they can deal with that issue in a far more straightforward fashion by requiring deposit-taking banks to spin off all of their securities activities, including underwriting and market-making. In practice, that would mean requiring Goldman Sachs and Morgan Stanley to give up their status as bank holding companies.

ACT STRONGLY AND UNIFORMLY ON DERIVATIVES

Dodd-Frank gave the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) the authority to regulate over-the-counter derivatives markets. This new authority recognizes that unregulated derivatives were a chief cause of the financial crisis that began in 2008. Because Congress had previously exempted some derivatives from rules governing financial instruments, the insurer AIG could use derivatives to take on potentially hundreds of billions of dollars in liabilities without setting aside a cushion of cash to fund possible payouts. And because such financial instruments did not trade on central exchanges, investors had no idea which financial firm dealing in such instruments might go bankrupt because of exposure to other financial firms.

The JPMorgan announcement should re-focus regulators on derivatives rules. Early reports indicate that JPMorgan executed its loss-making transactions via over-the-counter (as opposed to exchange-traded) credit-derivatives markets in London. If so, JPMorgan may have been able to avoid some rules that help make the financial system safer. First, banks with high credit ratings can often avoid putting significant capital down behind such trades; in fact, in early May, Citigroup warned that a ratings downgrade could force it to put up $4.7 billion in new collateral to counterparties.[6] Such disparate treatment of financial firms adds systemic risk to the economy, as sudden credit downgrades can trigger calls for more capital throughout the financial system, precipitating a credit crunch. Second, JPMorgan may have been able to

avoid regulatory scrutiny of these trades as it amassed a position large enough to pose danger to itself and to the financial system. Last, engaging in opaque derivatives can put customers at a disadvantage, as they cannot compare prices of different products and determine which is best.

Regulators have already completed much of their rule-making in this area. New rules will push "standardized" derivatives and swaps onto central counterparties (CCPs, or clearinghouses). The rules further will require participants in this market to put up consistent levels of capital (a way of limiting their borrowing via incurring potential liabilities).[7] These rules will help reduce borrowing and improve transparency.

A deficiency here is that regulators have allowed for exemptions that, if unchecked, could prove the undoing of the rules. Banks will still be able to hold "customized" derivatives on their books, for example. It is not clear that banks will have to put adequate margin behind these derivatives. Such exemptions could pose risks. To lessen that danger, regulators should ensure that customized derivatives remain a small fraction of the derivatives markets and a small fraction of financial firms' balance sheets in general. Regulators must also ensure that banks put hefty capital down behind any customized derivatives. Finally, America must encourage other jurisdictions, including Europe, to enact the same consistent rules, or it will see activity migrate to less-regulated areas.

Regulators should treat the JPMorgan example as a public case study. They should determine whether the new derivatives rules would have governed JPMorgan's activities, and if not, why not. They should determine, too, whether JPMorgan's trading counterparts were willing and able to demand collateral from JPMorgan on over-the-counter trades. If not, the financial system would still be vulnerable to an AIG-style situation, in which counterparties trust a seemingly safe institution to such an extent that the institution is allowed by the marketplace to take risks that put its viability in peril.

END "TOO BIG TO FAIL" BY TREATING ALL FINANCIAL FIRMS EQUALLY IN LIFE

To direct regulators' attention to future threats to the economy posed by large or complex financial firms, Dodd-Frank designated all large banks, including JPMorgan Chase, as "systemically important." The law further created a new board—the Financial Stability Oversight Council, or FSOC—made up of existing regulators to determine which smaller banks and non-bank financial firms, such as insurance companies or hedge funds, should be designated "systemically important financial institutions"—SIFIs—and which should not.

Regulators have significant discretion in choosing such firms. In April, they issued a 93-page rule to explain how they will determine which firms are particularly risky and which are not. But they do not expect to make their designations until the end of the year, at earliest. Regulators also have significant discretion about what to do about SIFIs, from counseling their break-up to asking them to hold more capital to asking them to submit additional reports to their regulators.

This approach exacerbates the "too big to fail" perception. Designating firms as SIFIs sends a signal to the marketplace that the government, not investors, is responsible for making sure that these firms do not fail. The market will assume that regulators would never let a SIFI go through the bankruptcy process as such an event would represent a government failure. The marketplace's reaction to the rumors, beginning in March and April, that JPMorgan was taking a large position in one opaque credit market could be an indication that this perception exists. The market might have punished a smaller player for taking such a position, with investors worrying that such a fund might not have the capacity to make good on its bets. The perception of a government guarantee not only distorts the market by allowing some firms to grow too big; it can distort individual markets by allowing large firms to take outsized positions. Indeed, all of the

attention given in Washington to the JPMorgan Chase loss shows that this perception exists in the political world and is intractable; lawmakers and observers should wonder not how the government could have prevented this loss, but whether the government could allow JPMorgan Chase to go bankrupt if the loss were big enough to end its viability.

There is no evidence that the government could take steps to mitigate this perception for as long as it officially considers some institutions to be "systemically important." Asking a large bank to hold, say, 12 percent capital instead of 8 percent, cannot make up for bondholders' perception that a bank has the backing of the U.S. government.

Regulators should instead say that they will not designate any non-bank as systemically risky, and that they will not treat the SIFIs that Congress has automatically designated any differently from how they treat other banks. By treating "systemically important" financial firms as ordinary financial firms in life, regulators can help the marketplace to understand that such firms will be treated as ordinary financial firms in death. That is, bad firms will fail without government aid.

END "TOO BIG TO FAIL" BY TREATING ALL FINANCIAL FIRMS EQUALLY IN DEATH

To prevent future bailouts, Dodd-Frank invested the Treasury Department and the FDIC with an "orderly liquidation authority." Regulators can use this power to wind down distressed financial companies outside of the traditional bankruptcy process. The provision is meant to avoid a repeat of the Lehman Brothers collapse.

Two years in, observers are uncertain of what this orderly liquidation authority means. Among other things, financial-firm executives, industry lawyers, and regulatory veterans are unsure whether regulators have the authority to guarantee bondholders, counterparties, and other creditors to a firm in a liquidation; whether regulators could use their new authority to wind down a company that is not a SIFI or even a financial company; or if regulators would have to respect creditor seniority in a liquidation.

Uncertainty in these matters distorts financial markets and retards economic recovery now. Investors may lend money to large banks too freely, for example, because they believe that the government would protect senior creditors in a future liquidation. In fact, in a *Meet The Press* interview two days after announcing his bank's loss, JPMorgan chief executive Jamie Dimon added to this perception, noting that if his bank ever failed, "the stockholders should be wiped out" and the bank's name "should be buried in disgrace." Yet Dimon said nothing about what to do with a failed bank's bondholders and big lenders. That's an important omission.

It is something that Washington has failed fully to grapple with, as well. Last week, for example, Martin Gruenberg, acting chairman of the FDIC, told attendees at a Federal Reserve Bank of Chicago conference that one goal, in winding down a failing financial firms, is "accountability": that is, to "ensur[e] that the investors in the failed firm"—including bondholders to bank holding companies—bear the firm's losses." Gruenberg offered some further details, noting that "the new resolution authority does not provide insurance or credit protection for creditors and counterparties, and creditors will always be subject to potential losses." However, the "accountability" goal came "second" on Gruenberg's list, after a "first" goal of "ensuring that the failure of the firm does not place the financial system itself at risk."[8] These two goals could conflict with each other, as they did in the 2008 crisis, and Dodd-Frank does not offer clear direction to regulators when the goals do conflict. Uncertainty in these matters could add panic in a future financial crisis. To avoid becoming hostage to a new and untested process, investors could pull their money out of financial firms ahead of any announced liquidations.

The best approach to liquidating financial firms would be for lawmakers to repeal the orderly-liquidation provision, making it clear that failing financial firms will go through bankruptcy. In the absence of this, though, regulators should be clear, both through words such as Gruenberg's as well as actions, that they will not take extraordinary steps to protect bondholders and trading counterparties in a firm's liquidation. Regulators should start holding regular simulations of their response to the failure of a large financial firm. Once a quarter, regulators should create dummy firms with dummy balance sheets and then play out their failure and liquidation. Regulators should create, too, different economic, financial, and political conditions that would impact these simulations.

Such exercises would get across one of two points to the marketplace and the public. Either regulators will allow senior bondholders and derivatives counterparties to take losses, or they will not. If not, the public can once again put pressure on Congress to change the law.

CONCLUSION

Two years after President Obama signed the Dodd-Frank financial-reform law, lawmakers, reporters, and the public are uncertain about whether the law has achieved its goals, even as JPMorgan's surprise trading loss highlights the economy's remaining vulnerability to financial-industry shocks. By focusing on the Volcker Rule, lawmakers are missing an opportunity to sharpen financial regulations so that markets, not regulators, can govern large financial firms.

ENDNOTES

[1] Carl Levin interview on "Morning Edition," National Public Radio, May 15, 2012.

[2] Remarks by the President at Signing of Dodd-Frank Wall Street Reform and Consumer Protection Act, The White House, July 21, 2010.

[3] The "Volker Rule for Financial Institutions (President Obama's remarks on financial Reform), January 21, 2010, http://www.whitehouse.gov/photos-and-video/video/volcker-rule-financial-institutions#transcript.

[4] "Dodd-Frank Wall Street Reform and Consumer Protection Act," http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf .

[5] "Notice of Proposed Rulemaking," U.S. Dept. of the Treasury, et. al., October 2011, http://fdic.gov/news/board/2011Octno6.pdf

[6] "Two-Notch Debt Downgrade For Citi Could Require $47B in Extra Collateral," Wall Street Journal, May 4, 2012.

[7] Dodd-Frank Act, U.S. Commodity Futures Trading Commission, accessed May 8, 2012.

[8] Remarks by Martin J. Gruenberg Acting Chairman, FDIC to the Federal Reserve Bank of Chicago Bank Structure Conference, May 10, 2012.