Has reform of global finance been misconceived? Policy documents and the Volcker Rule

Jamie Morgan & Brendan Sheehan

Abstract
The focus from mainstream economics on the global financial crisis has been relatively narrow, based on an underlying narrative and this focus has extended to and informed the majority of major institutionally commissioned reports, analyses and pre-policy documents, which might collectively be termed an elite position. Specifically, there has been a focus on the role of neoclassically informed theory as a cause of the crisis. This has tended to reduce problems of economic theory to problems of neo-classical economics and this then has helped to shape the context of engagement with problems of the global financial crisis. Much of the subsequent reform has been about preparing for failure rather than questioning why we have a system that fails and the issues here can be illustrated using the implementation of the Volcker Rule in the US.

KEYWORDS: Volcker Rule, financialisation, neo-classical, neo-liberalism, structural Keynesianism

Jamie Morgan
School of Accounting Finance and Economics, Leeds Beckett University, Rosebowl Building, Leeds, UK
01257 481274
jamiea.morgan@hotmail.co.uk

Jamie is co-ordinator of the Association for Heterodox Economics and co-edits with Edward Fullbrook Real World Economics Review, the world’s largest circulation open access economics journal. Jamie has published widely in economics, sociology, philosophy and area studies. His current research interests include financial regulation, modern forms of slavery, and ethics in economics.

Brendan Sheehan
School of Accounting Finance and Economics, Leeds Beckett University, Rosebowl Building, Leeds, UK
0113 81 24822
b.sheehan@leedsbeckett.ac.uk

Brendan is a senior lecturer in economics and political economy at Leeds Beckett University. He is a member of the Association of Heterodox Economists, the World Economics Association and the Scottish Centre for Economic Methodology. Brendan has published monographs on the economics of J.M Keynes and the economics of abundance. His research interests extend across all aspects of the economic dimension of the human condition, including different systems of global economy.
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Introduction

The Journal of Economic Literature is a highly influential mainstream economics publication. The journal functions primarily by invitation and publishes review essays by high-profile economists. In 2012 the journal published an essay by Andrew Lo, Professor of Finance at MIT. The essay 'Reading about the Financial Crisis', notes that there has been a great deal of diversity in terms of the specific focus of works on the global financial crisis (GFC), but also a common narrative (Lo, 2012: p. 177). What we want to suggest is that the underlying narrative has had significant consequences. This has been particularly so within mainstream economics and also in the majority of institutionally commissioned reports, analyses, and pre-policy documents, which we might collectively refer to as an elite position. Here we are interested primarily in the reports in terms of the links to the economics. A main focus has been the role of neo-classically-informed theory as a cause of the crisis. However, there is a basic tension here. The initial focus tends to reduce problems of theory to problems of neoclassical economics, as though resolving problems of neoclassical theory were sufficient to resolve problems of mainstream economic theory (see Lawson, 2009). There is then a further problem in so far as the focus on the economics helps to shape the context of engagement with problems of the global financial crisis and the issues here are ongoing.

Many reports and pre-policy documents pose the problem of theory in terms of market fundamentalism and then construct solutions as responses to the fundamentalism. This tends to follow a neo-classical logic and to reinforce the ideological aspects of competitive markets within neo-liberalism. Some ostensibly more critical approaches, meanwhile, can also fail here in so far as they do not, unlike, for example, a structural Keynesian approach, provide coherent theoretical support for an alternative. A great deal of subsequent policy has not been about definancialisation, but rather curbing excess and limiting losses. Ultimately this is an approach that prepares for failure rather than questions why we have a system that fails. This can be illustrated using the Volcker Rule regarding proprietary trading.

The problem as market fundamentalism

The focus on the role of neo-classically-informed theory as a cause of the global financial crisis has had a general form. The theory is posed as one of self-correcting dynamic markets where it is assumed that self-interested economic agents have incentives to seek out and use all available information. This neo-classically informed theory assumes an information rich environment in which appropriate economic decisions follow. All markets are effectively ‘clearing markets’ and there is a net outcome of growth. From the perspective of neo-classically informed theory the finance system was held to both epitomise this efficiency and also to augment it. Each financial innovation both created more
information (notably via derivatives) and also distributed risk to those with an incentive to be better informed. Proponents (e.g. Greenspan, Summers, Rubin) argued that the combination resolved an apparent contradiction between allowing bespoke markets for derivatives and securities and the concept that it is information that facilitates efficiency (see Morgan and Sheehan, 2014). The finance system could thus expand and financial innovations could spread based on a set of inter-related justifications. The claim was that finance, under this conceptualisation, helped to create growth (Morgan, 2009a, 2013). It did so by enabling more credit creation. It did so by becoming a source of growth in and of itself. And it did so by playing a role in dampening business cycles.

If one works through various commissioned reports and such, one finds that they construct a narrative within which it was misplaced faith in this concept of self-correcting dynamic markets that:

- Justified deregulation, such as the repeal of Glass-Steagall;
- Facilitated an endorsement of ‘light-touch regulation’, because financial markets were self-contained efficient users of information, and because risk had been quantified and dispersed;
- Provided a ready-made argument against reregulation when problems arose because private agents have the greatest incentive to resolve market problems; because markets learn from their mistakes; and because a ‘great moderation’ had in any case emerged as a new economic environment.

So, from this perspective the system was one in which over-confidence in dynamic self-correcting markets created a complacency in which problems could emerge. Those problems could not be recognized from within the conceptualisation (it assumed them away). Concomitantly they could not easily be recognized by key organizations (the regulators, economic analysts) because the system became both complex and opaque (ironically in the name of information).

The point we wish to emphasise is that the focus of the analyses is the role of market fundamentalism; the over-confidence, the faith. It is the fundamentalism that is being identified as a cause of the crisis. This identification occurs in different ways in different contexts. For example, the membership of the elite global consultancy/think tank the Group of Thirty includes many influential former central bankers, regulators and corporate executives, particularly from the major banks. Paul Volcker, former chairman of the Federal Reserve is among this number. The Group of Thirty has produced many reports in the wake of the GFC. For example, The Group’s Financial Reform: A Framework for Financial Stability report (Volcker, 2009) contextualises the GFC as both a market failure and a government failure (see also Volcker 2011: p. 8). It begins from the

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1 Specifically a bespoke market is not public and so typically has minimal reporting requirements reducing available information and this tends to contradict the general concept that markets function most effectively where information availability is maximised.
2 It is, however, a myth that the GFC was unexpected, see Cohen (2009).
statement that ‘confidence, taken for granted in well-functioning financial systems, has been lost in the present crisis, in substantial part due to its recent complexity and opacity’ (Volcker, 2009: p. 13). The implicit line of argument in the report is that it was the assumption that markets would simply deliver efficiency through competition that then led to a failure by regulators to construct the grounds of ‘fair and effective competition’ (Volcker, 2009: p. 18). The solutions is, therefore, not to assume that self-correcting dynamic markets will simply occur, they must be constructed and enabled through prudentially aware regulation:

The overall objective of the needed reform of the financial system must be to encourage diverse, competitive, predominantly privately owned and managed institutions and markets, able to efficiently and flexibly meet the needs of global, national and local businesses, governments and individuals. (Volcker, 2009: p. 17)

One finds this commitment repeated in many solicited pre-policy documents. For example, the UK Independent Commission on Banking (ICB) Interim Report April 2011 and Final Report September 2011. According to the ICB reports, the global financial crisis occurred because financial stability was assumed to simply follow from the efficiencies of the system; what is required now is a recognition that there should be ‘vigorous competition among banks to deliver the services required by well-informed customers’, but also a degree of regulation that improves information whilst continuing to plan for failures such that:

Information problems mean that supervisory regulation will never be perfect. In any case, it should not be the role of the state to run banks. In a market economy that is for the private sector disciplined by market forces within a robust regulatory framework. (ICB, 2011: p. 7)

The point we want to emphasise is that the fundamentalism provides the initial context in terms of which the problem is posed.

This focus can also be seen at work in the Group of Thirty report Towards Effective Governance of Financial Institutions (2012), headed by Jacob Frenkel a former professor of economics at Chicago and chairman of JP Morgan. According to the report all aspects of the GFC involved also a subtext of failure of governance. Corporations failed to recognize their own risk at the highest level and failed to create adequate checks and balances to control their risk. There was both an information failure and a failure to adequately process that information, partly because of an adverse culture of competition. The solution then becomes agency realignment and better information systems within mainly self-regulation i.e. a new dynamic culture built on better but not essentially different market principles. This simply reconstitutes a neoclassical ideal.

It is worth making two points here. First, the relationship between neoclassically-informed discourse and actual positions on policy and reform vary. In different instances one can consider such theory to have guided, caused or shaped responses (for its influence on Volcker’s thinking for example, see
Feldstein 2013; Silber, 2012). This is because different actors have different histories in regard of theory. Mainstream economists are consciously steeped in it and are also developers of its forms. It provides in one sense the limit against which the mainstream defines itself. Regulators, bankers and CEOs have been trained in its forms and absorbed elements of it as a framework for thought and for the expression of appropriate ideas. One reason why those ideas can seem common sense or appropriate is that they conform to the interests of those who advocate them, and the discourse here is far more than mere economic theory. It remains, however, that this is a complex issue not least because the term neoclassical itself is one that is complex and shifting. Here we are using it in the sense developed by Arnsperger and Varoufakis (2006) and Milonakis and Fine (2009). Each uses it to refer to a set of underlying characteristics and subsequent commitments that shape how theory is expressed and to what ends (see also Morgan, 2014).

Key characteristics include methodological individualism, a means-end instrumentalism, a focus on demonstrating equilibria and then the use of various technical apparatus to explore these in different contexts (functions etc., often with a strong commitment to specific model forms and mathematical proofs). These may seem abstract issues in terms of actual policy and interests but they readily translate into issues of optimisation for returns to organizations and key upper management, concepts of efficiency that treat labour as any other factor of production, concepts of rationality that justify amoral conduct as ultimately beneficial, and so forth. Importantly, one can still be neoclassical in a broad sense under this conception even if critical of some aspects of some theory. Under this conception, mainstream economics remains subordinated to underlying neoclassical commitments even when it seeks to position itself differently. Mainstream economics has become more sophisticated and varied in the last two decades in terms of acknowledging sub-optimality, constrained optimality, efficiency limits, rationality limits, price signalling distortions, preference disordering, the relevance of institutions in making markets etc. However, the underlying characteristics of theory remain the same and they are turned towards the construction of second best versions of the market outcomes prior theory, such as the efficient market hypothesis, has failed to deliver. How do we reconstruct efficiency and try to optimise, how do we make prices signal, enhance rationality, improve information quality etc. are questions that often condition responses, as economics translates into a policy discourse. This is also significant because it can condition or limit more critical approaches to financial reform.

For example, the UN Commission of Experts Report, chaired by Joseph Stiglitz (2009/2011) provided one of the earliest major sponsored critiques of the GFC. The Stiglitz Report is clear that the GFC was not just an unlikely event that

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3 So, for example, the New Keynesian Synthesis shares basic characteristics within the mainstream (Morgan and Sheehan, 2015)

4 That the mainstream is highly conflicted here was demonstrated in 2013 when both Robert Shiller, a mainstream critic of efficient markets and Eugene Fama, its chief architect, won the Nobel Prize for Economics (or more specifically the Sveriges Riksbank Prize, which was established 1968, and was not a part of Nobel's original conception in 1895).
occurred to the financial system. Rather the system itself was a cause of the crisis. In six chapters the Report acknowledges many different elements to the system. Issues like the stability of aggregate demand, trade imbalances, and reserve currencies are all referred to (e.g. 2009/2011: pp. 27-28). However, the narrative is one in which the assumptions of self-correcting dynamic markets are considered to be the primary problem of theory. It was faith in the theory that allowed the problematic practices to emerge and then facilitated a failure to place a check on them. A lack of transparency in key markets, the manipulation of asymmetric information, the misalignment of interests, the refusal to accept that an asset bubble can be identified etc. all follow from this (2009/2011: pp. 48-49, 57-58 and 60-61); as do many of the solutions offered, many of which are informed by Stiglitz’s work in information-theoretic and behavioural economics (see Morgan and Sheehan, 2014).

Of course, attributing a causal role to market fundamentalism is by no means incorrect. The associated failure of economic theory has been a profound one and recognition of this is important. The IMF’s Independent Evaluation Office (IEO) in its 2011 review of the IMF’s role in the GFC contains the important acknowledgement that:

The prevailing view among IMF staff – a cohesive group of macroeconomists – was that market discipline and self-regulation would be sufficient to stave off serious problems in financial institutions. They also believed that crises were unlikely to happen in advanced economies, where sophisticated financial markets could thrive safely with minimal regulation of a large and growing portion of the financial system.’ (IEO, 2011: p. 17)

However, the issue we want to raise and that ought to be beginning to emerge from what has been stated so far is that the focus can also have significant consequences for what follows.

**Fundamentalism is the problem to be addressed**

In so far as the problems are situated as ones created by market fundamentalism then the focus of solutions tends to be expressed as solutions to the *fundamentalism*: the ‘excesses’, the ‘distortions’, the misaligned interests, the failure to prevent certain organizational forms from growing unchecked... This emphasis suppresses a basic focus on critically exploring the *market* aspect of the phrase. This can have various ramifications. If the primary policy focus is to address the fundamentalism then this can simply mean seeking to self-consciously construct the market logic that markets fail to spontaneously produce. One introduces institutions and mechanisms to prevent excess, removes distortions, aligns interests, and makes more information more available. One seeks to create a transparent market in which choices can be rational, economic activity can readily express ordered preferences, and price signals can serve a free-floating function. Of course, it may remain impossible to perfect this perfection, since it relies on the ideal assumptions of a neoclassical position (rationality, ordered preferences etc.). However, the point remains that
the goal is to synthesise a market that can then be a clearing market. In so doing one seeks to construct some facsimile of the neo-classical archetype. Stating the problem as one that is resolved through strengthening regulation, oversight, and intervention can obscure this; and it can be obscured by reference to some alternatives to neo-classical economic theory, such as new institutionalism or information-theoretic economics. The focus on solving the problem of fundamentalism seeks to create what the fundamentalism could not sustain. Importantly, the focus on the fundamentalism is one that can marginalize or fail to recognize other potentially significant ways of considering the issue of the market.

Consider that the focus is often one that tacitly reduces the problem to one of any given and thus single markets. As such the problem ceases to be one of the system of markets. In Group of Thirty reports, for example, this is a simple reduction and isolation. The focus is typically on finance and banking and its facets. Unsurprisingly, specific commissioned policy advice documents such as the UK Independent Commission on Banking (ICB) reports follow a similar format.

Of course, it may seem absurd to criticise specific analyses and recommendation documents for their focus on their given subject – e.g. the mechanics of finance and its technical aspects. However, though a statement such as this report on finance is too much about finance may seem absurd, a statement such as this report on finance says too little about the world in which finance operates, seems less absurd. Finance becomes what it is because of the way it is integrated into a broader market economy. If the focus is on attempting to construct what the market itself could not sustain then the problem of finance is addressed in a way that does not also address the reasons why financial organizations have become ‘necessary’ and powerful. The concept of reform has become simply one of making the ideal function in some sense, rather than questioning whether this is either genuinely possible or desirable.

Consider again the previous quotes from Volcker (2009, p. 17) and from the ICB (ICB, 2011: p. 7). These are not simply statements about the proper functioning of a market they are ideological iterations that continue to assume a place for such markets in a system of markets. The balance of analysis and recommendation is towards controlling for excess rather than rethinking a system that may result in ‘excess’. There is a basic problem here. One is attempting to tame and stabilise entities that retain their significance within the system. As such, success can be an ever-present potential for failure because financial organizations remain powerful as actors with political influence and remain integrated into a market system that is vulnerable precisely because of the significance of finance as part of that system (see following).

The problem of focusing on the fundamentalism is relevant also when considering more critical accounts, such as the Stiglitz Report. The Report focuses primarily on the mechanics of different aspects of finance and banking. But it does so whilst recognizing that ‘The ideas and ideologies underlying key aspects of what have variously been called neo-liberalism, market
fundamentalism, or Washington consensus doctrines have been found wanting’ (2009/2011: p. 132). Clearly, there is recognition of a systemic issue here. However, the point of reference remains a rejection of fundamentalism in the form of self-correcting dynamic markets. The problem remains one in which neo-liberalism is essentially reduced to neoclassical commitments as though it were merely the narrow theory of spontaneous idealised markets that were the problem; and as though there were nothing else to neo-liberalism than this. The emergent solutions thus follow from addressing the fundamentalism. This rather undermines the critique of a Washington consensus based on the economics theory, as Sheila Dow noted in a prescient analysis:

The Washington consensus has evolved, such that good governance is now understood to be a necessary condition for the successful operation of free markets. This has extended the apparent purview of economics, but otherwise appears to leave the nature of the mainstream approach to the subject intact, albeit with a new interest in information asymmetry in competitive markets. (Dow, 2008: p. 18)

So it may be as the Stiglitz Report asserts that ‘Washington consensus doctrines have been found wanting’ but it is questionable how far the theory of economics held by those who contributed to the Report are a consistent alternative. In a general sense they are already integrated into the evolving Washington consensus.

Neo-liberalism and economics

Consider how the system looks from the point of view of an alternative position, such as the structural Keynesian or post-Keynesian critique (Palley, 2006, 2009, 2013b, Patomaki, 2013, Stockhammer, 2004, Sheehan, 2009). Amongst other changes the critique emphasises that within neo-liberalism the corporate focus on labour shifted from the link between wages and productivity to labour as a unit cost to be minimised. Unions and collective bargaining were increasingly viewed as distortions and frictions that reduced the efficiency of labour markets (which must now become flexible in order to more readily clear based on marginal productivities of labour). As unions weakened, lower wage growth and deskilling occurred, and outsourcing began to develop and a global supply chain emerged.

The result has been a system with a core tension: growth has occurred in the context of wage stagnation and income inequality. As such, aggregate demand has become unstable and subject to an accumulating ‘demand gap’. A neo-liberal corporate globalization has increasingly provided the context in which labour has been pressured. Workers in the US and other developed economies compete with workers in developing economies, driving down wage growth in the developed economies (whilst also maintaining relative low wages in developing economies because of poor unionisation and exploitation based on neo-liberal

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5 For the origins and evolution of neo-liberalism see Mirowski & Plehwe, eds. (2009), Mirowski (2013).
Finance has thus become significant in various ways. Most importantly it has been used to fill the demand gap by acting as a source of debt creation. Financial innovation in the context of deregulation enabled ever expanding financial organizations to supply credit that was now necessary to the growth model as well as to the household/consumer. Simultaneously, finance organizations provided a variety of outlets (hedge funds, private equity and securities) for those (high net worth individuals and some proportion of capital from institutional investment) who sought ‘yield’ from the asset bubbles that a low interest rate central bank policy fuelled (Morgan, 2009b). Finance thus emerged as a set of increasingly powerful actors on a global scale. This financialisation could not be stable despite the power of finance because the whole was and still is built on a basic problem of income inequality and wage stagnation, based on a break between wages and productivity. Asset bubbles by definition are unstable and debt servicing by the many in a system that expands faster than both wages and incomes has real limits. Both make the system prone to disastrous positive feedback loops (whose familiar logic can be found in the work of Minsky or Kindelberger).

There is more one might say here but the outline should be clear. The structural or post-Keynesian position provides a clear sense of what the underlying problems are – they are systemic dynamics. Free trade has not been free trade it has been a debilitating form of private control of enterprise, maintained by a neo-liberal ‘policy tool box’ that extends from key states to a regional and global level. Finance is not simply a set of organizations that can be shaped to, as Volcker put it, ‘meet the needs of global, national and local businesses, governments and individuals’. Finance is a set of powerful actors with their own concerns able to act back upon the system that has made them powerful and into which they are now integrated. The idea of them meeting some pre-existing need is naïve at best.

Importantly, the structural or post-Keynesian account of the system is founded in a consistent and coherent theoretical position that brings together the organization of corporations and of policy and also a critique of mainstream economics theory. The point we want to emphasise here is that there can be a quite different point of departure than that provided by the narrow focus of analysis. One can place the issues of finance in both systemic and theoretical context, within which finance then becomes significant. Clearly, the more narrowly defined and instrumental approaches fail to do this. However, more critical elite analyses, such as the Stiglitz Report are also problematic, despite some superficial resemblance. One might think of these as forms of a ‘Gattopardo’ problem. Palley (2013a) uses this term to refer to economics theory that selectively absorbs some of the insights of alternative positions but without consistently reconstructing the theory based on the significance of those insights. This Gattopardo problem extends also to a problem of reform initiatives.

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6 Minsky is mentioned once and only to dismiss him as incompatible with rationality in Bernanke’s account of the Great Depression (his expertise in which was the main reason Bernanke was appointed to the Fed) (2000: p. 43).
Change to stay the same?

The point we want to emphasise is that the current system is open yet path-dependent. It developed and can thus be developed out of. Narrowly focused analyses tend to focus on regulation to construct archetypes. However, this implies that regulatory failure was the primary cause of the crisis. This in turn reduces the political pressure to consider the systemic causes of the crisis, except in so far as one responds to the fundamentalism – the complacency, the misplaced faith. Not only does this rely on a neoclassical position as the goal to be (in so far as one is able) constructed, it tends also to accept the ideological function of a neoclassical position (labour remains primarily a unit cost to be minimised, unions remain distortions etc.), and so perpetuates the systemic problem.

So, what the various institutionally commissioned reports ultimately reveal is restricted scope. It is no great surprise, of course, to conclude that organizations such as the Group of Thirty have a limited sense of change, but the point is nonetheless important. The more critical reports have failed to gain traction and the more instrumentally focused have contributed to the general framing of the problem of finance in a way that has helped to close down the issues. The changes that have occurred have not been about addressing the very nature of financialization, or of the integration of the finance system into the rest of the economic system and into daily life, they have followed directly on from the focus on the fundamentalism. They are about planning for the worst, curbing excess and so limiting the potential for the worst, whilst also addressing the distribution of losses. They are about preparing for systemic failure rather than fundamentally rethinking why we have a system that fails. This kind of focus carries its own contradiction since the planning, curbs and limits can also fail precisely because the system remains one primed for failure. One can illustrate this with reference to policy. Here we use the Volcker Rule; similar points might be made regarding ring-fencing in the UK, or the Bank for International Settlements macro-prudentialism.

The Volcker Rule in the US, 2010 to 2014 and beyond

The US Dodd-Frank Wall Street Reform and Consumer Protection Act was signed into law July 2010. Its most controversial aspect, receiving greatest criticism from lobbyists and industry bodies was Section 619, ‘Prohibitions on proprietary trading and certain relationships with hedge funds and private equity funds’, colloquially termed the Volcker Rule (US House, 2010: pp. 245-256). The Volcker Rule is, ostensibly, a form of prohibition on forms of financial activity. The Rule was a late addition to the legislative deliberations. Treasury Secretary Timothy Geithner and Larry Summers, then Director of the President’s advisory National Economic Council, did not favour prohibitions, preferring a greater focus on capital structures for banks. However, in December 2009, Paul Volcker persuaded Obama of the need for some kind of prohibition and in January 2010 Obama publically endorsed the idea.

The Volcker Rule
Section 619 of the 2010 Act inserts a new section into the existing US Bank Holding Company Act 1956 (US House, 2010: p. 245):

(1) PROHIBITION – Unless otherwise provided in this section, 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.

The Act defines a banking entity as one that is subject to oversight in the US by an insured depository institution i.e. one that can call on the state (US House, 2010: p. 254) and defines proprietary trading as ‘engaging as the principal for the trading account of the banking entity’ i.e. trading on behalf of the bank for the bank in any of a subsequent list of instruments (securities, derivatives etc. US House, 2010: p. 255). The point of Section 619 is to address two ways in which banks may generate losses for which the state may become the guarantor.

First, if a bank can profit from trading on its own behalf it has an incentive to commit capital to trading and to tacitly reduce its various forms of secure capital. Typically such trading is short term and involves complex financial instruments and leverage. This can make the bank vulnerable in various ways. Its real capital base may not be sufficient to protect it from losses. Its balance sheet may be loaded with complex financial instruments (in a constant state of turnover). It may be subject to conflicts of interest with clients who are direct counterparties or who have counter-interests (and be unaware of the Bank’s interest due to asymmetric information and also institutional ‘Chinese walls’ within the bank). The aggregate effects of many banks engaging in such activity may also be detrimental to financial stability, since proprietary trading will tend to increase the number of securities and derivatives being produced and traded and adds a layer of additional actors whose very existence relies on exploiting opportunities (such as the absence of information available to clients of other parts of the bank).

Second, if a bank either owns and operates a hedge fund (through a management team) or has a significant equity stake in a hedge fund, then it faces further conflict of interest issues. Hedge funds, like proprietary trading desks, exist to exploit opportunities (defined in some contract that focuses the investment strategies of the fund as a pool of capital). For example, an events led hedge fund identifies some trend or outcome in markets and positions itself to profit from that – such as a housing market crash. John Paulson’s hedge fund, for instance, effectively shorted the US housing market in 2007 and 2008 by taking out credit default swaps on collateralised debt obligations. In similar circumstance a bank-operated hedge fund would have an interest in the collapse of the value of securities that another arm of the bank may actually be issuing to clients. In so far as the bank’s senior management team are aware of the reasoning of the hedge fund they are also aware of the potential problems (the basis of the bet) of any securities they are actively marketing to clients.

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7 Section 619 also distinguishes non-bank financial companies but this is not relevant here.
The first important point to make here is that the Volcker Rule appears to be a prohibition but one has to consider carefully what this means. The Rule does not prevent particular trading activities it seeks to limit the capacity of banking entities, which the state may have to rescue, from directly undertaking those activities. It is for this reason that Occupy and organizations like Better Markets have supported the Rule (Treasury, 2013: p. 10 fn 27). We by no means wish to suggest that the Rule is worthless or should not be supported (in a better than nothing sense). But we do want to make the broader point that the Rule is limited and is essentially a preparation for failure. The system into which finance is integrated remains essentially the same.

Section 619 was signed into law in 2010. Since then hedge funds have continued to increase in numbers and in terms of capital invested – the general context of the search for yield has continued and has intensified via zero-bound interest rate strategies and quantitative easing by central banks. According to Hedge Fund Research total capital invested in hedge funds exceeded pre-crisis levels in the first quarter of 2011 at $2.02 trillion, and capital has continued to increase thereafter – to $2.6 trillion in the final quarter of 2013 (HFR, 2014). The number of recognized hedge funds increased 2009-2013 to more than 10,000.

So, if hedge funds are problematic then the introduction of the Volcker Rule has had no significant impact on the existence of hedge funds or the attractiveness of them as a place to invest capital. Moreover, if the point is to prevent losses within banks that may then be passed to the state then the impact is also limited. The bank entity may not own or have a large stake in a hedge fund but the bank is not restricted in its capacity to be a prime broker to hedge funds. The protection of the bank’s balance sheet may, therefore, be limited. If a hedge fund is leveraged and experiences problems the bank is in the position of creditor who may not be paid the full sum that is owed. The bank is still exposed to losses. Moreover, the bank and the financial system at large are still exposed to the problem of margin calls and death spirals. If a hedge fund starts to collapse, a bank will accept/seize new assets as collateral. The bank can still find itself absorbing complex financial instruments. The existence of those instruments will still become a connective problem and both the bank and the system can still be subject to problems of valuation of those instruments (creating uncertainty that spreads destructive positive loops).

The problem, moreover, is simply one aspect of the continued existence of shadow banking. Shadow banking is a system of financial intermediaries that provide credit, construct and trade securities, conduct credit transformations (switching long and short term credit instruments) and proliferate chains of debt using securities as collateral. According to US Treasury Department and Federal Reserve research, shadow bank liabilities in the US system were conservatively estimated at $17 trillion for 2012 (Pozsar et al, 2013: p. 6). This was $5 trillion

More specifically, the final form of regulation (following lobbying, see later) allows a bank to maintain a $10 million stake or, if less, up to 3% of Tier 1 capital in a hedge fund/PEF. They cannot be prime broker to their own fund but can to others; and some forms of fund (debt distress) are exempt.
less than the 2007 peak. Significantly the difference was due to a slowdown in activity rather than regulation. Shadow banking remains unreformed;\(^9\) and its components constitute an ‘extra layer of fragility’ in the system (Pozsar et al 2013: p. 12) and:

> It remains an open question whether the parallel banking system will ever remain stable through credit cycles [...] the reform effort has done little to address the tendency of large institutional cash pools to form outside the banking system. Thus we expect shadow banking to be a significant part of the financial system [...] for the foreseeable future. (Pozsar et al, 2013: p. 14)

Hedge funds, it should also be noted were not the immediate trigger of the global financial crisis (though they were a link in the chain since they were a key source of demand for securities to use as collateral, Lysandrou, 2012). The credit crunch arose because of the complex inter-connections and the existence of various debt securities, whose construction was based on models (still being used in modified forms today). The Volcker Rule does not remove banks from this complex financial system web, including shadow banking.\(^10\) It does not reduce the potential significance of hedge funds in their relations with banks rather than within banks.

This brings us to the issue of proprietary trading in general. The existence of the Volcker Rule has not prevented bank entities making major trading losses. The nature of those losses tells us something about what will be a major problem in terms of the Volcker Rule. Proprietary trading is defined as trading on behalf of the bank for the bank. This definition seems quite clear cut. However, trading by a large bank typically has multiple contexts and can thus be justified under different rationales. For example, consider the case of the ‘London Whale’ Bruno Iksil who made reported losses of $6.2 billion at JP Morgan Chase, in April-May 2012 from a credit derivatives position. Iksil worked for JP Morgan’s Central Investment Office (CIO) in London. The remit of the CIO is to manage structural interest rate, currency, and credit risks created by the day-to-day activity of the bank’s primary business. The CIO is a unit intended to provide a hedging function for the bank, offsetting risk on the balance sheet. Iksil’s position and the losses incurred were not in any simple sense a matter of proprietary trading, and were not represented by JP Morgan as such.\(^11\) Hedging activities by the major banks it should be noted are not balance sheet neutral, units like the CIO are expected also to be profitable. According to Bloomberg (2012), the CIO manages a portfolio exceeding $200 billion.

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\(^10\) Again, the final form of the regulations allows banks to sponsor securitization vehicles. It was these that devastated Citi Group.
\(^11\) The position was reported to be the sell side of credit default swaps in the index CDX IG 9, which offers contracts on 121 major US companies. There were so many contracts sold on the index that it became cheaper to buy protection through the index than take out CDS on the individual companies, creating an arbitrage problem.
Taking the Iksil trade as represented by JP Morgan – a poorly managed hedge – one can make the point that banks, as with the issue of hedge funds, remain vulnerable despite the Volcker Rule because they are integrated into a complex financial system and have reasons to engage with that system. The vulnerability in the Iksil case arises from the continued existence of speculative markets grounded in credit default swaps. One can make the further point that the case illustrates an ongoing problem for the Rule: where is the line between proprietary trading and other rationales for bank activity?

_The Volcker Rule is not a rule_

The legislation encoded in Section 619 is not actually a rule, it is a general statement followed by a set of initial exemptions and conditions and then a further set of directions that empower specific bodies to develop and implement actual rules over a subsequent duration. The exemptions and the development and implementation of actual rules thereafter create scope for the Volcker Rule to be significantly weaker than the concise statement of the prohibition might imply.

Section 619 specifically excludes US Treasury securities and the securities of Government Sponsored Enterprises (GSEs: Freddie Mac etc. US House, 2010: p. 248). There is no limit on proprietary trading in these assets. Clearly, legislators did not want to destabilise the market for government debt and mortgage provision at a time of greatly increased government debt and a housing market crash. But this is a purely pragmatic point and not an argument that holdings ‘safe’, meaning there is no potential problem for the bank's balance sheet or financial stability. The GSEs had to be rescued in the global financial crisis, so any rule construction that privileges holdings of GSE assets would seem to be potentially dangerous (since it provides the basis for a housing bubble). One might argue that Treasury securities are AAA rated and it is diminishingly unlikely that the state will default. But this is to assume that default can only occur because of an inability to pay when the broader problem is that a failure of bipartisanship might trigger brinksmanship and a refusal to pay (an ongoing problem in US politics). Moreover, there does not need to be a default in US Treasuries for the privileging of holdings in sovereign debt to have perverse effects. Encouraging banks to hold sovereign debt tends to reduce capital allocated to productive investment – so the Volcker Rule actually serves to maintain the flow of capital in the finance system rather than causing it to flow out into production – not only perpetuating problems of economic recovery but also enhancing financialised relations.

This brings us to the line between proprietary trading and other rationales for bank activity. Section 619 permits trade in securities for the purposes of market making (US House, 2010: p. 249); the bank entity can hold sums of securities and instruments to provide ordinary liquidity to the market (offering services as buyer and seller to connect the market for clients). The bank is also permitted to engage in:
(C) Risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts or other holdings. (US House, 2010: p. 249)

Market making creates the problem of what holdings constitute ordinary liquidity. Acknowledging that there is a legitimate need to hedge and this can be of aggregated positions creates the problem of blurring; what is a hedge, when any position may also be profitable? The Isik case indicates, even if considered a hedge and thus designed to reduce risk, hedges do not necessarily reduce risk.

The point here is that ambiguity arises and this creates further problems for the development of the rules that follow (as it has before, see Persaud, 2003). The rules need to specify what is market making and what will constitute a hedge. But the specifications can only create further complexity and necessarily require implementation, dispute and testing by case, creating scope for weakening of the rules. This has only just begun in 2014. This will occur in a context where the banks remain integrated into the complex web of the financial system. The process will not simply involve mishap, where banks find themselves inadvertently within the remit of Section 619; it will involve specific attempts to test the boundaries of the Rule in specific markets.

Section 619 directs the Federal Financial Stability Oversight Council (FSOC) to produce a study 6 months after the date of enactment of the Act. It then directs key US regulatory and oversight bodies to initiate the development of a coordinated formulation of specific rules for trading practices not later than 9 months after this 6 months deadline. The Act then allows for a further period of development and consultation. The FSOC published its report January 2011, and the regulatory and oversight bodies ran their initial development and consultation process from October 2011 to February 2012. The Act then formally became effective in July 2012 but a period of conformance was allowed so that

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12 The final form of the regulation following lobbying allows that a bank can engage in market-making in any financial instrument but its inventory is limited to ‘reasonably foreseeable’ demand from potential clients; this is open to significant interpretation. Moreover, the bank itself is directed to construct an internal compliance program with position limits for each trading desk; this is self-monitoring and self-imposition. Hedging compliance requires the bank to monitor and report on its overall hedging rather than individual trades; it must ensure that the hedge creates no new risk; this is meaningless since the very point of hedging is to create a known risk (to cover or reduce an existing risk). ‘Liquidity management’ is exempt from proprietary trading but the rules do not define clearly what this is – merely that it is permissible to engage in it using ‘highly liquid’ securities; again these are not defined; one can assume liquidity for an asset right up until the point a crisis makes a market illiquid and this can apply to any asset; how does one assess this for structured products that are rarely traded? The regulations also exempt bank derivatives clearing transactions - a bank can take positions to clear markets for third parties; so banks with major roles in derivatives markets are still able to engage in that activity and can position themselves to profit as they clear a market; furthermore, that activity is still in markets that can be systemically dangerous based on particular events. At the same time the regulations direct banks not to expose themselves to ‘high-risk assets’ but do not define what is a high-risk asset (in given market conditions anything can be high risk – the bank can always claim that it is only in retrospect that this becomes recognizable).
Bank entities need not establish compliance until July 2014, and thereafter, the period of conformance could be extended on a year-by-year basis for another 3 years. 2014 is 6 years after the main trigger of the global financial crisis and 4 years after Section 619 became law. It may be 2016 or 2017 before it is fully operational. So, it is significant to note that though Dodd-Frank was enacted in 2010, Section 619 did not become meaningful law at this point – it became a legislated statement whose final form and significance could be delayed by key financial actors and could be disputed by them. As the regulatory and oversight bodies note, a long list of major banks and finance industry bodies provided written submissions calling for the rule to be re-proposed or further delayed (Treasury, 2013: p. 6 fn 16). The consultation process received 18,000 submissions.

The initial published document from the US agencies is 963 pages (Treasury, 2013). So the initial 11 pages of Section 619 became 963 pages by the end of 2013, and this is before any additional substantive test cases occur. One might of course think of this as a process of construction of careful and nuanced regulation, seeking to cover all possible eventualities. But this kind of clarification creates two problems. First, the process of construction enables compromises concerning wording and these are significant. The new regulation, for example, requires bank entity Chief Executive Officers to sign statements that they have compliance systems in place, but it does not require them to confirm that they are compliant and this would be quite different. The difference tells us something. The density of regulation is rooted in a form of legalism – one responds to a problem by more specification. However, this invites responses that rely on the precise specifications and works to exploit them. It invites a focus on the specific phrasing of, and the absences in, the regulation, rather than conformity to the spirit or intent of the original law. How that focus will be motivated will depend on the interests of the participants engaging with the regulation. The bank’s are on record as opposing Section 619. Their interests are bound up in returns on equity, shareholder value, and the opportunities to create profit in a financialised system. They have every motive to weaken Section 619 over the coming years. A recent article in the premier professional tax trade journal describes the Volcker Rule as subject to ‘cognitive capture of the regulators’, reducing to ‘self-monitoring’ in practice, and essentially ‘unenforceable’ because of its complexity; a complexity which the reviewer notes will also keep his colleagues in gainful employ for years to come (Sheppard, 2014). The line between hedging and proprietary trading will not be easy to draw. As that line is drawn, well-resourced banks will be able to call on the best legal teams available, as well as sophisticated knowledge of finance. As many regulators around the world have noted, they find it difficult to match the resources of the banks. This itself is a legacy of financialisation.

13 For example, dispute resulted in commodities trades being exempt from proprietary trading rules; banks are major traders in oil and accept oil assets as collateral on short term financial activity with counterparties seeking liquidity for various purposes. Concomitantly, repo activity is not subject to proprietary trading regulation and can be done without limit; since collateral for repos (including oil contracts) can be used in multiple chains and these can involve significant leverage, there can be the potential for contagion.

14 Though the core is 71 pages; Dodd-Frank is 848 pages and Glass-Steagall 53.
Conclusion

It seems clear that regulatory approaches such as the Volcker Rule cannot solve fundamental problems. They are an attempt to curb excess and limit losses. Ultimately, regulation along these lines is preparation for failure rather than a challenge to a system that fails. There is limited worth in this kind of approach. It does not seek a coherent way to definancialise the system. One way in which a systemic challenge has been marginalised has been through the narrative construction of theory in relation to reports and analyses of the global financial crisis. Many of these pose the problem in terms of market fundamentalism and then construct solutions as responses to this. This tends to follow a neo-classical logic and to reinforce the ideological aspects of competitive markets within neoliberalism. More critical approaches can also fail in so far as they do not provide coherent theoretical support for an alternative. Financial stability cannot simply be built from within the financial system. One must also address the system that gives rise to financialisation. The fundamental issues are the dependence on and influence of finance. A different global political economy requires us to address these. It requires us to recognize that a great deal of current reform discussion suffers from anosognosia (lack of appropriate awareness of the true context of one’s illness). A great deal of reform as currently posed is ‘necessary’ because of the system in which it is to be inscribed (limiting, curbing etc.) but can never be sufficient because of that system.

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