Final demolition of Volcker Rule lights up derivatives risk

On 26 June US financial regulation agencies the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) approved moves to strip the last vestiges of the Volcker Rule. The rule was the only useful part of the 2010 *Dodd–Frank Wall Street Reform and Consumer Protection Act*, a pretence at reining in the speculative excesses that led to the 2008 global financial crisis.

The new ruling means banks can invest in previously banned speculative capital funds, and no longer have to put aside money to allow for losses in derivatives trades made with their bank or non-bank affiliates. They will not have to post “initial margin”, a small percentage of each trade, as collateral on initiation of inter-affiliate derivatives contracts, unless their total exposure exceeds 15 per cent of Tier 1 capital.

Bloomberg reports that the scrapping of affiliate margin requirements could free up some US$40 billion for banks to use. Some, like Rob Nichols, president and CEO of the American Bankers Association, say the change will “allow banks to further support the economy” with more loans; but as with Fed easing and bailout programs the impact is never as advertised, with the bulk of funds measurably flowing into vastly more profitable speculative ventures.

Wall Street is happy: the Dow Jones “industrial” index made a near 300-point jump upon the news. So are the banks, which have long argued that having to post initial margin on affiliate trading limits their profitability.

In its original form the Volcker Rule stated that banks could not engage in proprietary trading; could not obtain equity in, own or engage with a hedge fund, covered fund or private equity fund; and must hold margin for derivatives trades with its affiliates. The banning of proprietary trading—where a bank trades in its own funds in competition with its clients—was already wound back in 2019, now the other regulations have gone too. Analysis by a number of experts who over the last few years opposed the watering down of the legislation, clarifies how the changes will make the banking system more dangerous, right when it is on the brink of implosion.

Transferring risk to the public

In an article for *American Banker* published 18 October 2019, “Don’t mess with rules curbing derivatives risk”, Dennis Kelleher and Joseph Cisewski, both from US financial reform organisation Better Markets, wrote: “The very purpose of inter-affiliate derivatives transactions is to transfer risks between legal entities and, most often, to move risks into US dealer banks that have control or custody of deposits and customer funds.

“If the foreign affiliate is not adequately capitalised and properly regulated, the US bank essentially inherits the foreign affiliate’s risks. That is why both Congress and most US financial regulators, prior to the recent proposal, rightly insisted that US banks protect depositors and customers by collecting initial margin from affiliated derivatives counterparties.” (“Move to unchain derivatives raises ghost of AIG”, *AAS*, 30 Oct. 2019)

Relaxation of these rules in the USA will have a big worldwide impact. According to Kelleher and Cisewski it threatens US financial stability, and due to the interconnected nature of derivatives will act as a mechanism for transmitting financial risk. The five largest US banks, backed by taxpayers, concoct almost 90 per cent of US derivatives deals; the same five US banks “also dominate the global markets through foreign affiliates, which facilitated much of the roughly US$542 trillion in derivatives notional outstanding as of 2017”.

The changes will also allow deposit-taking banks to “add risk to their balance sheet” by investing in private venture capital and credit funds and permit a “greater degree of ‘parallel investment’ alongside covered funds”, Securities and Exchange Commissioner Allison Herren Lee said in a February statement.

Federal Reserve Board Governor Lael Brainard warned that “The proposal opens the door for firms to invest without limit in venture capital funds and credit funds”. This undermines the intention of the Volcker Rule, as legislated by Congress, which was based on an understanding that “Some credit funds played a material role in the [2008] financial crisis”; they were not transparent and misled investors. “Venture capital funds are a type of private equity fund. As such, they pose similar risks”, she added.

In a 30 January statement, Commissioner Rostin Behnam of the Commodity Futures Trading Commission (CFTC) reminded readers that “When the agencies approved the changes on proprietary trading in September, the late Paul Volcker himself sent a letter to the Chairman of the Federal Reserve stating that the amended rule ‘amplifies risk in the financial system, increases moral hazard and erodes protections against conflicts of interest that were so glaringly on display during the last crisis’. I can imagine that he would say something very similar about the further changes that we propose today, particularly the erosion of the existing protections regarding conflicts of interest."

Ultimately the Securities and Exchange Commission, the CFTC and the Fed approved the proposal. One of the four FDIC board members voted against the rule: former chair Martin Gruenberg said it leaves regulations "severely weakened" and "risks repeating the mistakes" of the 2008 financial crisis. "Today's final rule would allow the largest, most systemically important banks and bank holding companies once again to engage in investments and relationships with high risk funds that resulted in large losses, and contributed to the failure or near failure of large financial firms in the 2008-09 financial crisis", he said in a statement. A former head of the FDIC (2006-11), Sheila Bair, told CNBC that giving the banks more leeway was a road we'd gone down before, and was "ill-advised". The Fed's Brainard reiterated that the move "could again leave banks exposed to the build-up of risky derivatives". Cisewski warned the shift has increased risk to the system "and jeopardised the savings of every American with money deposited at Wall Street's biggest FDIC-insured banks that are involved in global derivatives dealing".

Only a return to full Glass-Steagall banking separation, which prohibits any overlap between federally insured deposit-taking banks and today's untrammelled speculative bubble, will prevent the coming tsunami of losses from engulfing depositors and taxpayers.

By Elisa Barwick, Australian Alert Service, 1 July 2020

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