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THE WRONG RISKS: WHAT A HEDGE GONE AWRY AT JPMORGAN CHASE TELLS US ABOUT WHAT'S WRONG WITH DODD-FRANK

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What can we learn from JPMorgan Chase's recent self-proclaimed "stupidity" in attempting to hedge the bank's global risk position? Clearly, the description of the bank's trading as "sloppy" and reflecting "bad judgment" in this case was designed to prevent the press reports of large losses from being used to justify the introduction of more stringent regulation of large, multifunction financial institutions. Just as the large banks have characterized the recent financial crisis as a black swan riding on a 100-year flood that could not have been foreseen or prevented (although JPMorgan Chase had managed better than others), the bank's trading losses, we're told, were simply due to an individual's "bad judgment": just as black swans happen, people will make mistakes—there is really nothing that can be done about it.

Indeed, much of the follow-up to the loss announcement has concentrated on whether or not JPMorgan Chase complied with regulatory disclosure requirements or was dutifully transparent in providing details of the trades that produced the losses with investors. It has also been stressed that neither full restoration of the Glass-Steagall Act nor the implementation of Dodd-Frank's "Volcker rule" would have prevented the actions that produced the losses. Indeed, in the pre-

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Gramm-Leach-Bliley days, Bank One (Mr. Dimon's former employer) was one of the first banks to use derivatives to hedge its overall credit exposure. The discussion of the losses incurred by the Chief Investment Office (CIO) has thus been framed to drive everyone to the obvious conclusion that the only remedy was to deal rapidly with the people responsible for the "terrible, egregious mistakes," and the bank did move quickly to clean up and reorganize the CIO.

But the lessons to be drawn are not to be found in the specifics of the hedges that were put on to protect the bank from an anticipated decline in the value of its corporate bond holdings (although it seems that the net result of the positions used to hedge a long position was to increase the long position—which, if not stupid, was a truly novel hedge), or in any of its other global portfolio hedging activities. The first lesson is this: despite their acumen in avoiding the worst excesses of the subprime crisis, the bank's top managers were unable to monitor and assess the inherent risks in an activity of a unit that responded directly to them. Indeed, when the problem was first recognized it was dismissed as being equivalent to a "tempest in a teapot." Clearly, JPMorgan Chase's management did not have a good idea of its exposure, which serves as evidence that the bank was "too big to manage." And if it was too big to manage, it was clearly too big to regulate effectively. Further, although the number of permanent supervisors proliferated in the bank (reports are of over 100 regulators permanently present in the bank), apparently none were responsible for this unit or considered it a source of risk.

But even more important is the apparent mandate of the CIO, which was tasked with investing JPMorgan Chase's "excess deposits" in such a way as to hedge its exposure to portfolio holdings of high-risk corporate debt. It is presumed that these deposits were in excess to those it is required to hold in order to meet its reserve requirements against loans. And there were a lot of excess deposits because the bank was not creating new deposits by lending to finance investment and job creation. Clients were presumably drawn to entrust deposits to JPMorgan Chase because it was considered to be well managed, but also because it is one of the banks that is considered to be "too big to fail" (TBTF). Clients made these deposits because they were insured by the Federal Deposit Insurance Corporation up to $250,000, but many also held larger deposits because they believed that these deposits would be effectively managed on the basis of the bank's track record in surviving the financial crisis unscathed.

In the aftermath of the recent crisis, most banks with excess deposits have held them with the Federal Reserve or in Treasury securities. JPMorgan Chase, on the other hand, appears to have adopted another strategy and increased its exposure to risky corporate debt and even riskier collateralized debt obligations. This suggests that it was not only the excess deposits, but also the bank's own funds that were being invested in risky trading positions in even riskier assets, rather than being directed toward activities that support economic activity.

This raises the larger question of just what, exactly, a TBTF bank is expected to do with the supposed advantages of its large size. The current answer is to maximize remuneration to the bank's traders (and, indirectly, to the bank's shareholders), and it appears that the errors that were made in JPMorgan Chase's hedging strategy were linked to an attempt to earn income from selling credit insurance on the same kinds of assets whose losses it was attempting to limit. There is another way to make money to remunerate shareholder capital, but it is perhaps less lucrative for the bank's traders: namely, making loans to finance business. And this is the most salient lesson of this affair, because it highlights the role of the regulatory system.

Here, Glass-Steagall provides an important lesson. First, it limited the activities of banks to a level that was not too big to manage, nor too big to fail. Going back to Glass would restrict banks to a size that would allow for effective regulation, while also allowing management to have a clear idea of the risk exposure of its activities. The former president of the Federal Reserve Bank of Kansas City and the current president of the Federal Reserve Bank of Dallas have both called for action to reduce the size of financial institutions.

But, as pointed out in a recent Levy Institute report,[1] simply making banks smaller will not solve the problem if they are left to engage in the same kinds of activities that led to the losses at JPMorgan Chase and are to be expected at other TBTF institutions. More important, as Hyman Minsky pointed out, Glass-Steagall was designed to direct bank lending toward the financing of investment in productive activities that would generate future income and employment. The risks that a bank incurred in this scenario were linked to the ability of entrepreneurs to identify investment opportunities that would produce an income stream sufficient to pay back the loan and earn a competitive market rate of return. Here, the risk concerned the income generated by the project being financed, and such projects required the employment of labor and the production of real output for the market. A bank's activities thus benefitted not only its shareholders but also entrepreneurs and workers. It was the bank's role to adequately assess these risks and adjust its interest rates and portfolio appropriately.

However, since the passage of the Gramm-Leach-Bliley Act in 1999, the major activity of banks is to profit from changes in the prices of the assets held in its trading portfolio—and for JPMorgan Chase, in its hedging of its global portfolio. This activity generates little new investment and virtually no employment. If the bank guesses right, it makes capital gains for its shareholders; if it guesses wrong, and other banks have made the same guesses, the government and the general public are called upon to bear the losses. The problem is not simply that the banks are too large; it is that they generate shareholder returns by betting on changes in asset prices in their portfolios rather than by betting on investments in real productive activities that create income and employment for the economy as a whole. JPMorgan Chase is important because it incurred losses by speculating with its clients' deposits to hedge its speculation on the prices of assets, not by speculating on the ability of entrepreneurs to identify profitable, employment-creating opportunities. The problem with the current Dodd-Frank legislation is that it does nothing to induce banks to return to lending to finance growth in income and employment, but rather seeks only to make their trading activities less risky. The recent experience at JPMorgan Chase suggests that this approach will never work. The problem is not whether banks are allowed to engage in global portfolio hedging under the limits of the soon-to-be-proposed Volcker rule; it is that they are engaging in the wrong kinds of investments and the wrong kinds of risks. In Minsky's view, effective regulation should ensure that banks provide financing for the capital development of the economy, as well as the personal wealth of their traders and shareholders.

Note

1. See *Using Minsky to Simplify Financial Regulation*, a research project report released with the support of the Ford Foundation in April 2012 by the Levy Institute program on Monetary Policy and Financial Structure.