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Even After Volcker, Banks Aren't Safe Enough

By Rana Foroohar

Despite the hoopla over the approval of the Volcker rule, which restricts banks from making certain types of speculative investments, our financial system isn't much safer than it was before 2008. The fine print in the rule--named for inflation-quashing former Fed chair Paul Volcker--shows the extent to which our system is still vulnerable. Banks used to be the servants of American business. Now they are its masters.

FDIC vice chairman Tom Hoenig, perhaps the smartest banking reformer around, helped sharpen this point in a recent speech in which he noted that from 2008 to 2011, commercial and industrial loans to American businesses declined from $1.6 trillion to $1.24 trillion. While banks would say this is because demand sank during the crisis, the Alliance for American Manufacturing argues that it was because credit tightened so dramatically, even businesses with strong prospects couldn't get loans. I'm inclined to believe the manufacturers, since they've actually experienced a substantial renaissance in recent years.

To be sure, the Volcker rule has strengthened some of the language regarding how and when banks can do risky securities trading, which is much more profitable than the plain-vanilla lending they've been moving away from since the 1980s. The rule is a step in the right direction. But it is naive to pretend that the too-big-to-fail problem is gone. For starters, the biggest banks are even bigger now than they were before the crisis: the eight largest financial institutions in the U.S. control nearly $15 trillion worth of assets, or about 90% of GDP. As Hoenig sums it up, "I don't know any manager who can safely handle a single institution that's holding $3 trillion to $4 trillion worth of assets." In other words, he is warning, the banks are not only too big to fail but also too big to manage.

A major reason for the continued complexity and risk in the financial system is lobbying power. The Volcker rule as Volcker originally envisioned it was a brief document that did something simple: it separated federally insured commercial lending to businesses and individuals from high-flying trading of the kind that can result in London Whale--type losses. The Volcker rule as it stands now has been turned into Swiss cheese by bank lobbyists, who represent the second biggest corporate special-interest bloc after the health care complex, spending nearly half a billion dollars a year on lobbying, according to the nonprofit, nonpartisan Center for Responsive Politics. So while the rule limits federally insured banks from trading for its own sake, they are still allowed to hedge their portfolios, which opens up a lot of gray territory for trading. The truth is, it will take years to know how effectively the current version of Volcker will mitigate risk in the banking system. And ultimately it will depend on how much time, money, technology and legal services the banking industry throws at keeping the most profitable portion of its business going.

There's a case to be made that the industry might grow more robustly if bankers were forced to separate lending from trading. Many of the largest and most complex firms trade at a discount from their book value, suggesting that the market isn't so confident about their future performance. Certainly having more lenders rather than fewer would help other kinds of businesses, and having trading walled off from lending would encourage that. The fact that the five largest U.S. financial holding companies control 55% of industry assets--compared with 20% in 1990--keeps competition low and credit constrained.

So where do we go from here? hoenig believes that in the next two to five years, there will likely be another crisis or trading loss of the kind that reignites the debate over closing trading loopholes and creating a truly safer financial system. Reformers like him believe that there should be limits, for example, on the amount of borrowed money that banks can use to conduct their daily business. Right now, banks complain about rules that would require them to hold a mere 5% of their assets in high-quality, low-risk capital (known as Tier 1 capital), despite the fact that in any other industry, doing business with less than 50% of your own cash would be considered extreme.

There is a rising chorus of reform voices that would like to see banks holding more like 15% to 20% of their own capital. That was the average held by the major New York--based institutions in the run-up to the financial crisis of 1929--which is one reason none of them went under back then. As the U.S. recovery gains steam and memories of the 2008 crisis fade, here's hoping we haven't lost our last, best chance to create a safer system.

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