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Big JPMorgan Loss Renews Debate On Curbing Bank Risk

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JPMorgan Chase's (JPM - News) $2 billion trading loss has renewed concerns about how the nation's largest banks manage risk and raised doubt as to whether the 2010 financial overhaul adequately protects taxpayers.

Overnight, CEO Jamie Dimon seems to have gone from exhibit A in the case that too-big-to-fail banks can be safely run without tighter regulatory handcuffs to exhibit A that they can't.

In one respect, the shift may be unwarranted: The trading loss looks like a superficial wound — not even big enough to wipe out half ofJPMorgan's Q1 profit. At least when it comes to absorbing this particular loss, "too big" may not be so bad.

But banking experts understand that financial crises are a fact of life. As long as banks are playing with federally insured deposits — and an implicit broader bailout backstop — taxpayers have an interest in making sure they don't take on excessive risk.

That's where the Volcker Rule, passed as part of the Dodd-Frank reforms, is supposed to come in. But the rule remains unfinished as regulators struggle to translate Congress' mandate to keep banks from taking risky bets into clear, workable guidelines.

Rep. Barney Frank, D-Mass., sounded a note of vindication: "The argument that financial institutions do not need new rules .. . is at least $2 billion harder to make today.

Yet it's unclear if the Volcker Rule would even restrict the activity that burned JPMorgan. Dimon suggested on Thursday's conference call that the trade in question was done to hedge risk and, therefore, would be permissible under the Volcker Rule.

The rule targets proprietary trading — making trades not to provide customers with liquidity or hedge risk, but for pure profit.

"The Volcker Rule judges very much by the intent" behind a trade, said Brookings Institution scholar Douglas Elliott. "If a bank does its hedging incompetently," that's beyond the ability of regulators to police, he said.

And for good reason: "If we didn't have these exceptions, (the Volcker Rule) would effectively forbid a large majority of the things that banks do.

Elliott, for one, is no fan of the Volcker Rule, which aims to ban unnecessary risk, rather than preventing excessive risk-taking. In that sense, it seems designed to rid bank culture of a "trading mentality," he said.

Other analysts also see it as somewhat besides the point in heading off financial crises.

"Banks usually go broke from making bad loans," not proprietary trading, said American Enterprise Institute banking expert Alex Pollock.

It's unclear where the new push to rein in financial risks will lead. Dallas Federal Reserve President Richard Fisher again called for breaking up the largest banks. Without referencing JPMorgan directly, he said: "At what size do you not realize what's going on underneath you? If you've gotten to that point, you're too big.

Among think-tank types, there is surprising agreement that Dodd-Frank leaves taxpayers exposed to too-big-to-fail bank bailouts and about at least one step that could help.

Massachusetts Institute of Technology Professor Simon Johnson wants to make the largest banks hold equity equal to 10% of assets. That would provide a sizable cushion for losses, limiting the risk that government will rescue bondholders in addition to depositors.

While not his first choice, Cato Institute financial regulatory director Mark Calabria sees the 10% equity idea as reasonable.

"If you have some sort of expansive safety net for banks, you have a reasonable responsibility to reduce the risk," he said.