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Senate "Whale" Report Underscores Need for Strong Derivatives Reform and Ironclad Volcker Rule

The findings of the Senate Subcommittee on Investigations, headed by Carl Levin of Michigan and John McCain of Arizona, should reinforce the will of legislators and regulators to reduce the complexity, excessive risk-taking, and overwhelming size of the biggest banks. At a time when too many in Washington are once again echoing the "What's good for us is good for America" mantra of Wall Street lobbyists, the Senate's "London whale" inquiry makes a compelling case for stronger and more effective financial regulation.

We applaud Chairman Levin, ranking member McCain, and their colleagues for this excellent report. While others on Capitol Hill have been trying to roll back derivatives regulation or repeal the Volcker rule, the Subcommittee has unearthed evidence of massive gambling, accounting manipulation, and cover-up which should shred any argument for retreat from Wall Street reform.

Thanks to the new report, we know beyond doubt that:

- JP Morgan was not engaged in hedging or "market-making." Its traders were using depositors' money - and taxpayer subsidies - to gamble for their own and the company's profit. That is exactly what the Volcker rule prohibits. And contrary to the claims of JP Morgan and other big banks, the distinction between legitimate hedging of risk and dangerous proprietary trading is a clear one. (JP Morgan's "hedging" defense was largely concocted after the fact with the help of a public relations expert.) The difficulty lies not in the proper recognition of hedging, but rather in the ability of regulators to act forcefully against an industry determined to hold onto the enormous rewards of prop trading.

- Far from being the work of a single "London whale," these trades were managed by a team of bankers acting at the behest of senior management.

- Financial institutions of this size are not only too big to fail or jail, but too big to easily police. Left largely to its own devices by the OCC (under previous leadership), JP Morgan played accounting games to hide its losses from shareholders and regulators alike. The company "outmaneuvered its regulator, keeping the Synthetic Credit Portfolio off the OCC's radar despite its massive size and three months of escalating losses, until media reports pulled back the curtain on the whale trades" (p. 14). When its activities could no longer be concealed, the bank came up with a series of improvised cover stories.

- This kind of high-risk trading has become pervasive among the biggest financial institutions. As long as the opportunity is there, they will take advantage of every legal ambiguity to juice up their profits at the expense of others, taxpayers included.

- Congress was absolutely right to insist, in the Dodd-Frank Act, on much tighter derivatives regulation and bank oversight.

- There is no substitute for clear rules, full disclosure, and tough enforcement. Self-regulation will not work. Despite its reputation for sophisticated risk management, JP Morgan repeatedly altered a key risk-calculation metric in order to keep these dangerous trades from coming to light.

- Oversight agencies must follow through with writing a strong Volcker rule, bringing the derivatives markets under effective control, and completing the rest of the Dodd-Frank agenda. Elected officials should be trying to protect regulators from industry bullying, not joining Wall Street in ganging up on them for trying to do their jobs.