Harvard Law School Forum on Corporate Governance

Hedging Under the Volcker Rule

Posted by Hal Scott, Harvard Law School, on Thursday, July 12, 2012

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Editor's Note: Hal Scott is the director of the Program on International Financial Systems at Harvard Law School and the director of the **Committee on Capital Markets Regulation**. This post is based on a statement from the committee, available **here**.

Debate continues around the proposed regulations to implement the Volcker Rule, most lately around its provisions related to permitted hedging activities. As the **Committee on Capital Markets Regulation** (CCMR) has commented in the past, the proposed regulations should be appropriately constructed to address activities that are specifically permitted under Dodd-Frank, including market-making, underwriting and hedging.

Following the recent JPMorgan (JPM) trading losses, some have called for tightening or even removing the provisions for portfolio hedging that are incorporated in the proposed regulations. Dodd-Frank permits hedging on aggregated positions but critics suggest this should not be interpreted to allow hedging on a portfolio basis. Despite the JPM losses, however, CCMR believes that portfolio hedging should in general be permitted.

Portfolio hedges are crucial for banks to reduce overall volatility and risk. Overly restricting hedging would actually increase bank risk, the very outcome the critics themselves seek to avoid. Suggestions that portfolio hedges need to be correlated to individual underlying positions are both unworkable and overlook the reality that banks seek to hedge their overall mix of assets, and potential movements across an entire portfolio, rather than single movements of individual assets. Furthermore, correlations evolve over time and hedging is a dynamic process.

JPM's trade began as a hedge against a deterioration in credit conditions. However, early in 2012, JPM tried to offset its hedge position in a way that, according to JPM Chairman and CEO Jamie Dimon, "created new and potentially larger risks." Dimon himself said the strategy to offset the hedge was "flawed, complex, poorly reviewed, poorly executed and poorly monitored." Whether or not the resulting positions would, at some point, have been prohibited under the Volcker Rule, the initial purpose of the trade was to reduce risk to the bank and, when properly executed, hedges serve a critical role in risk management.

JPM's losses should thus turn our focus to the regulators' challenge in defining permitted activities under Volcker. The agencies proposing regulations to implement the Volcker Rule acknowledged: "the delineation of what constitutes a prohibited or permitted activity…often involves subtle distinctions that are difficult both to describe comprehensively within regulation and to evaluate in practice." That the proposed regulations go on for 298 pages is further evidence of the difficulty of this task. Instead of attempting to draw bright lines around permitted activities including hedges, perhaps a better approach would be a more collaborative one where regulators in their supervisory capacity work together with the firms they oversee to examine overall positions and determine whether they are permissible.

If regulators restrict banks' flexibility in their hedging strategies, they will leave banks unable to mitigate entity-wide risks. As a result banks will likely reduce lending, which would have a substantial impact on the real economy. Recent studies on hedging suggest that banks (like JPM) that used credit derivatives for hedging were able to maintain a higher level of lending during the financial crisis. Perhaps even more alarming though, banks that cannot hedge will become much riskier. Moreover, U.S. banking entities will be at a competitive disadvantage to domestic and international competitors who continue to have the flexibility to hedge against the risks that they deem appropriate.

This is not to say that some changes may need to be made as a result of the JPM experience. In particular, regulators should focus on guiding banks to improve internal risk management policies and procedures, and possibly consider qualification requirements for directors on a board's risk committee, and they should also address any inadequacies in their own oversight of banks. Reporting and central clearing of credit derivatives—the products at the center of the JPM trades—will also bring greater transparency to the market, ensure appropriate collateralization and consistent pricing, and minimize any systemic consequences of similar future events.
