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Political Power and American Public Policy

26 September, 2012

In 2007 and 2008, the global financial system was brought to its knees. Obscure terms like mortgage backed derivatives, subprime lending, and credit default swaps suddenly entered everyday vernacular. Although the average citizen may have struggled to comprehend the complexity and scope of this crisis, it was impossible to overlook the massive problems which had developed in the US banking system. As academics, capitalists, regulators and politicians debated possible changes, a prominent voice began advocating a seemingly simple solution. Paul Volcker, former chairman of the Federal Reserve, proposed new regulation which was intended to limit the risks financial institutions could incur. After years of contentious deliberation, the eponymous ‘Volcker Rule’ nears implementation but in a much different form than the original draft.

Kraft and Furlong describe public policy as, “what public officials within government, and by extension the citizens they represent, choose to do or not to do about a public problem. Public Problems refer to conditions the public widely perceives to be unacceptable and therefore requiring intervention.”[[1]](#footnote-1) In the aftermath of the worst economic crisis since the great depression, Americans had clearly identified problems within the banking sector. As a result, a primary agenda item for President Obama and the Democratic controlled congress was to pass legislation which regulated the financial system. In 2010, politicians responded to public pressure by passing the Dodd-Frank Wall St. Reform and Consumer Protection Act, which included the Volcker Rule.

Dodd-Frank is one of the most far reaching and complex pieces of legislation ever. By contrast, the Volcker Rule was intended to be short and simple. The core component of the rule is a ban on proprietary trading by commercial banks. It also contained a stipulation that large depository institutions could not invest in private equity organizations, like hedge funds. Proprietary trading is when a financial institution uses its own funds to invest in a variety of potentially unpredictable securities in an effort to profit or hedge against risk stemming from market volatility. This was identified as a problem because if these trades went the wrong way, it could potentially threaten the solvency of an entire institution.

Before the 1990’s, commercial banks were prevented from engaging in these speculative practices because it endangered their depositors funds. These regulations were implemented in the wake of the Great Depression and survived for half a century as part of another piece of legislation known as the Glass-Steagall act. The new policies drew a line between commercial and investments banks by defining the different operations each type of institution could practice. During the gradual and sweeping deregulation of the 80’s and 90’s many of the barriers separating the two were removed.[[2]](#footnote-2) This policy change was aggressively pushed by financial firms and it received support from republicans as well as democrats. When the Subprime Mortgage Crisis occurred, many policy experts thought deregulation caused excessive and widespread risk to accumulate and spread throughout the market.

Stable financial markets are seen as a fundamental public interest in a free-market economy. In a capitalist democracy like the United States, regulating these markets is seen as a primary responsibility of the federal government. It does this through the central bank and The Federal Reserve System, as well as legislation. Congress passes the laws, but responsibility for implementation falls to independent regulatory agencies in the executive branch like the Securities and Exchange Commission (SEC), Federal Deposit Insurance Corporation (FDIC), and Federal Trade Commission (FTC). After congress passed the Volcker Rule, the task of constructing and approving the final version went to a new regulatory board, The Financial Stability Oversight Board, which was created through the Dodd-Frank financial reforms.[[3]](#footnote-3)

The proposed changes have languished with regulators for over two years. In that time, there has been a considerable push by the large financial firms, through their numerous lobbyists and friends on Capitol Hill, to water down the final regulations. They were able to secure approval for propriety trading “in areas where regulators believe healthy markets would not exist without Wall Street’s own trading.”[[4]](#footnote-4) These concessions were called into question earlier this year when JP Morgan, one of the most vocal opponents of the rule, suffered a huge loss on the same type of trades the new regulation sought to limit.[[5]](#footnote-5) This scandal has reignited a simmering controversy and today a final version of the Volcker Rule has not been approved.

Through the Subprime Mortgage Crisis, the American public was alerted to pervasive problems in their banking system. The government addressed the public demand for regulation by passing the most sweeping changes to the financial system since the Great Depression. Limiting the risks incurred by commercial banks engaging in proprietary trading was one of the most important and high profile policies included in this legislation. The Volcker Rule, as it came to be known, will soon be implemented, but the scope and significance remain undetermined.

**Sources**

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Wyatt, Edward. "Panel Begins to Set Rules to Govern Financial System." The New York Times 18 Jan. 2011: online. <http://www.nytimes.com/2011/01/19/business/19rules.html>

1. This is the definition of Public Policy and Public Problem which I will use in this essay.

   Kraft, Michael, and Scott Furlong. *Public Policy: Politics, Analysis, and Alternatives. 2nd ed*. Washington DC: CQ, 2007. Print. [↑](#footnote-ref-1)
2. Most analysts believe this contributed to varying degrees but it remains a contentious topic in public policy. Kenneth A. Carow, Edward J. Kane and Rajesh P. Narayanan. *Journal of Money, Credit and Banking*. Vol. 43, No. 7 (October 2011) (pp. 1371-1398). Online. [↑](#footnote-ref-2)
3. Before 2010 , this regulatory board did not exist. The establishment of new regulators is consistent with responses to public pressure stemming from public problems.

   Wyatt, Edward. "Panel Begins to Set Rules to Govern Financial System." *The New York Times* 18 Jan. 2011: online. [↑](#footnote-ref-3)
4. These include markets for government bonds, commodities, and currencies.

   "The Volcker Rule." Times Topics: *The New York Times*, Online. [↑](#footnote-ref-4)
5. The firm lost upwards of $2 billion on a proprietary hedge made by a trader in London. It is not clear how restrictions on proprietary trading in the US would affect the operations of multi-national financial firms like JP Morgan.

   Cushman, John, and Edward Wyatt. "Bank Regulations Gain Fresh Support." *The New York Times* 11 May 2012: Online. [↑](#footnote-ref-5)