Statement of the U.S. Chamber of Commerce

ON: The Dodd-Frank Act's Impact on Asset-Backed Securities

TO: The Subcommittee on Capital Markets and Government Sponsored Enterprises

BY: Tom Quaadman, Vice President of the Center for Capital Markets Competitiveness

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The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on issues are developed by Chamber members serving on committees, subcommittees, councils, and task forces. Nearly 1,900 businesspeople participate in this process.

Chairman Garrett, Ranking Member Maloney and members of the Subcommittee on Capital Markets and Government Sponsored Enterprises. My name is Tom Quaadman, and I am Vice President of the Center for Capital Markets Competitiveness ("CCMC") at the U.S. Chamber of Commerce ("Chamber"). The Chamber is the world's largest business federation, representing the interests of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations, and is dedicated to promoting, protecting, and defending America's free enterprise system. I appreciate the opportunity to testify before the Subcommittee today on behalf of the businesses the Chamber represents.

I would like to thank Chairman Garrett, Ranking Member Maloney and the members of the Capital Markets and Government Sponsored Enterprises for holding this important hearing, *The Dodd-Frank Act's Impact on Asset-Backed Securities*.

The American economy has the most innovative and diverse financing system in the world.[1] Efficiency is one of the key drivers of this system. The more efficient our financial system is, the greater its capacity to support business growth and economic expansion. If our financial system is efficient there are a number of resulting benefits: it is easier for businesses to obtain the resources needed to grow and operate; more new companies are launched; more companies can go public; businesses can manage risk more affordably; and there is greater availability of consumer credit (which is an important source of initial financing to many entrepreneurs). In other words, a diverse, well-developed, and efficient system of capital formation is necessary for robust economic growth and increased employment.

Our financial system has been one of the most innovative sectors of our economy. While many western industrialized economies have lumbered forward

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[1] In testimony given before the Subcommittee on Capital Markets and Government Sponsored Enterprises for the October 24, 2013 hearing entitled: *Legislation to Further Reduce Impediments to Capital Formation*, the Chamber included, as appendix A, a 2011 study released by the Chamber authored by Professor Anjan Thakor of Washington University entitled, *Sources of Capital and Economic Growth: Interconnected and Diverse Markets Driving U.S. Competitiveness* ("Thakor Study"). The Thakor Study found that a key factor for small business success and resulting growth and job creation is their ability to access financing. The Thakor Study had five key conclusions:

1. A robust, efficient and diverse financial system facilitates economic growth;
2. In terms of their financing choices individual entrepreneurs are largely limited to debt financing for raising capital;
3. As businesses grow they can access both debt and equity financing and the mix of these two, called the "capital structure" decision, is an important choice every business makes;
4. A rich diversity of financing sources is provided by the U.S. financial system; and
5. The U.S. financial system is highly connected and what happens to one financing source causes spillover effects in other parts of the system. So for example, if excessive regulation restricts access to, or the operation of, the IPO and secondary markets for publicly traded companies, the resulting loss of liquidity will act as a disincentive to private equity and venture capital activity as well.

wedded to traditional, static financial sectors, American entrepreneurs and the financing systems that support them have proven adept at finding new ways to finance American business. For instance, this has taken the form of non-traditional use of financing, such as home equity loans for small business owners, or the use of new technologies such as securitizations.

Securitization has been used for decades, and while it is most closely associated in the public eye with home mortgage financing, it has in recent decades come into widespread use as a form of business financing. Securitizations allowed for robust financing that, when used judiciously, permitted the safe dispersion of risk and eventually grew to encompass a large segment of the debt markets.

We are all aware of the problems with mortgage backed securities comprised of poorly-underwritten sub-prime mortgages and their role in the financial crisis. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") attempted to address these problems through the risk retention provisions contained in Section 941 of the Act. The Chamber initially supported the concept of risk retention. However, as I will explain in greater detail, this has unintentionally targeted forms of business financing that performed well during the financial crisis.

Securitization has become a vital component of our system of finance over the past two decades and now provides a critical source of funding alongside more traditional balance sheet lending. It is important to note that not all securitized products are the same – there are different classes of underlying assets, different structures, and contrasting credit risk profiles. It is also important to note that other securitization asset classes did not experience the wholesale meltdown experienced by subprime RMBS. Uniform application of the rules to different products would heighten the risk that the rules could adversely affect credit availability.

The regulations implementing Section 619 of the Dodd Frank Wall Street Reform and Consumer Protection Act prohibiting proprietary trading by financial institutions (the "Volcker Rule") is having an immediate impact upon certain forms of capital formation used by businesses to obtain the resources to grow and create jobs. The Chamber repeatedly wrote to, and met with, regulators urging them to consider the impacts of the Volcker Rule upon the ability of non-financial businesses to raise capital.[2] As the Volcker Rule will not become fully operational until the end of the conformance period in July, 2015, the problems I will discuss today will only be the first of many problems that will impact non-financial businesses. These impediments

[2] *See* comment letters of October 11, 2011, November 17, 2011, December 15, 2011, January 17, 2012, February 13, 2012, February 14, 2012, April 16, 2012, November 16, 2012, September 25, 2013, November 7, 2013 and November 25, 2013 from the U.S. Chamber of Commerce to the regulators and FSOC.

to capital formation are not only confined to the Volcker Rule, but to other portions of the Dodd-Frank Act as well.

The best current example of such impediments is how Collateralized Loan Obligations ("CLOs") are adversely impacted by both the Volcker Rule and Risk Retention regulations.

CLOs are a form of a securitization, but more like a hybrid combined with a portfolio loan. Having grown over the course of time, CLOs provide business financing to companies in 47 states and the District of Columbia that collectively employ over five million Americans. CLOs are primarily used as a non-investment grade vehicle and give small-, midsize-, or challenged-businesses a stream of capital formation. A broad swath of corporate America participates in this market, including companies from the health care, energy, retail, entertainment, and telecommunications sectors, to name just a few.

Because CLO portfolios are managed and comprised almost exclusively of senior, secured non-real estate corporate loans, they performed well during the financial crisis. The CLO market performed largely as expected during the financial crisis. Unlike structured products based on subprime mortgages, many of which experienced considerable losses in recent years, investment grade CLO tranches experienced very few aggregate losses.[3] In the past 16 years combined, CLOs have experienced a cumulative *impairment* rate of approximately 1.5%, and the actual *loss* rate was even lower, which is well in line with investor expectations. The Federal Reserve Board acknowledged a low default rate for CLO collateral in its Report to Congress on Risk Retention in October 2010, citing the aligned incentive mechanisms inherent in CLO structures.[4]

The Chamber expressed serious concerns that the regulators had failed to take into account the impact of the Volcker Rule upon the capital formation of Main Street businesses. An economic analysis, as required under the Riegle Act, may have been able to identify harmful impacts upon Main Street businesses, but no such study was undertaken with the Volcker Rule. While it appears that the regulators tried to address some of these concerns, the issue regarding Collateralized Loan Obligations shows that the financial regulators may have missed the mark, and this failure has real-life consequences that are harmful to the overall economy.

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[3] In fact, most CLO debt downgraded during the crisis has been subsequently upgraded with most originally rated AAA tranches still rated at least Aa- or better, even under new stronger requirements from the agencies. CLO mezzanine debt, originally rated below investment grade, will not take any losses and CLO equity outperformed original pre-crisis expectations.

[4] *See* Board of Governors of the Federal Reserve, Report to Congress on Risk Retention, October 2010.

CLOs provide over $300 billion in financing to thousands of businesses. One surprising, and troubling, development in the final rulemaking on the Volcker Rule is the excessively broad definition of "ownership interest." This definition is used to determine whether a bank owns an interest in a covered fund, like a hedge fund, that must be divested under Volcker. The regulators far exceeded the requirements of the statute, and their definition of "ownership interest" includes not only equity in such a fund, but also the "right to participate in the election or removal" of the investment manager. In so doing, regulators swept certain bank bond portfolios into a prohibition directed at hedge fund ownership.

As a result many banks are being forced to sell off debt like CLOs and may not participate in offering such notes in the future. CLO notes are clearly debt, not equity, and have a long track record of stable and steady performance – the historic default rate of CLOs is under 1.5%, and the loss given default much lower than that. These are assets that withstood the stress of the financial crisis, and continue to trade at or close to par.

Why would banks be forced to divest a safe debt instrument under a provision of law intended to cover hedge funds? Because the highest rated class of CLO debt carries with it the right to participate in the selection of a new investment manager if, and only if, the CLO equity owners remove a poorly performing manager for cause, prior to an actual default. This right is a prudential creditor protection—it permits senior creditors to have a voice in actions taken to avert disaster. In a sense, this is the same type of power that we want our prudential regulators employing with respect to a troubled financial institution.

U.S. banks currently own about $70 billion worth of CLO debt. Foreign banks whose operations are subject to Volcker own about $60 billion in addition to this. Any effort to restructure this amount of debt would be overwhelming. As a result, we are likely to see banks begin to sell off these performing assets, which would put downward pressure on prices and start a rush to liquidate. Ironically, this would benefit hedge funds and others who can purchase strong, performing assets at steep discounts, but it would remove significant capital from the banking system. Equally important, this will remove a major source of liquidity from the CLO market, and make it harder for business that need the CLO market for loans to find the financing that they need to operate grow, and create jobs.

These concerns are also no longer theoretical. Bloomberg has recently reported that CLO issuances in the United States were down by 60% in January and that some forms of CLO activities are now migrating to Europe.

Accordingly, the Chamber supports the discussion draft introduced by Representative Barr. The Barr discussion draft corrects the defect of the Volcker Rule by aligning the definition of ownership interests to CLOs that exist as of December 31, 2013. This would prevent the fire sale of existing CLOs that harm the institutions that hold them and depress the existing markets harming new CLO issuances. Passage of the Barr discussion draft would also allow the regulators the time to fix the potential adverse impacts of the Volcker Rule upon Main Street businesses. The Chamber also believes that the Barr discussion draft should include a requirement that a comprehensive study of Dodd-Frank rules be conducted to better understand the interaction of various regulatory initiatives and their impacts upon Main Street businesses.

The Chamber has repeatedly called for a comprehensive study of the cumulative impacts of Dodd-Frank and Basel III upon the capital formation capabilities for Main Street businesses. As an example, the failure to have a clear derivatives end-user exemption could hamper the ability of a company to mitigate risk; the Volcker Rule may impede the ability of businesses to raise capital in the debt and equity markets; Basel III could harm business lending through negative risk weights for commercial lines of credit; while looming money market fund regulations may hurt the ability of businesses to access the commercial paper markets and use effective cash management techniques.

The one place these initiatives converge is with the business trying to raise capital. If the business cannot raise capital, or only do so in a less liquid and more expensive environment, then businesses cannot grow, create jobs, or may even have to shutter their doors. For these reasons, the Chamber last year issued a study *How Main Street Businesses Use Financial Services* [5] to show how businesses use financial services. A comprehensive study of the cumulative impacts of these regulatory initiatives upon this diverse mosaic of capital formation is needed before Basel III and certain Dodd-Frank Act provisions, such as the Volcker Rule, are implemented.

This may only be the first wave of capital formation problems that may crop up as a result of the Volcker Rule. Accordingly, the Chamber supports the introduction and passage of the Barr discussion draft to correct the ownership interest definition for CLO's and preserves an important and necessary form of financing for Main Street businesses.

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[5] The study can be found at: http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/CCMC-Main-Street-Businesses-Survey_summit1000pdf.pdf

CLOs are also not solely impacted by the Volcker Rule. The proposed risk retention rules also restrict the ability of Main Street businesses to use CLOs. It should be noted that the Qualified Residential Mortgage rules carve out the mortgaged back securities that contributed to the financial crisis, but that business financing such as CLOs, which were not a cause of and performed well during the financial crisis, are still subject to the proposed risk retention rules.

CLOs are not the type of originate-to-distribute securitizations that the risk retention rules were designed to address. CLO managers already have "skin in the game" by virtue of a number of unique characteristics embedded within the CLO structure, including the fact that managers receive a majority of their fees only after investors get paid. Notwithstanding the aligned interests between managers and investors, the proposed rule requires that CLOs provide that the "sponsor" must retain 5% of the fair value of a new CLO. This would mean more onerous requirements for CLOs than for other asset classes, as the proposed "5% of fair value of the CLO" retention requirement exceeds the requirement applicable to other asset classes. Under the proposed rule, the CLO sponsor remuneration is restricted until the CLO notes begin to amortize. Since CLO notes do not begin to amortize until the end of the reinvestment period, which occurs years into the future, this restriction on cash flows would render the economics of such an arrangement unworkable.

In conclusion, I would like to note that this Committee is to be commended for the leadership it has demonstrated curtailing the problems associated with Volcker Rule implementation. Again, the Chamber believes that a comprehensive review of the impact of Dodd Frank and other regulatory initiatives undertaken in the wake of the financial crisis are warranted to prospectively identify other impediments to capital formation for business.