Statement of the U.S. Chamber of Commerce

ON: Examining the Impact of the Volcker Rule on Markets, Businesses, Investors, and Job Creation

TO: House Committee on Financial Services, Subcommittee on Capital Markets, Securities, and Investment

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The U.S. Chamber of Commerce 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. 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.

Good morning Chairman Huizenga, Ranking Member Maloney and members of the Subcommittee on Capital Markets, Securities and Investments. My name is Tom Quaadman, executive 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 and organizations of every size, sector, and region. I appreciate the invitation to testify today on behalf of the businesses that the Chamber represents.

It is an honor to be invited and testify at today's hearing: ***Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation***. This is the latest in a series of hearings on the impact of the Volcker Rule upon the financial system and the broader economy.

The Chamber opposed the Volcker Rule at the outset because of the foreseeable negative consequences of the rule, such as restricting market-making and underwriting activities, which in turn impact the ability of businesses to obtain the financing needed for short-term operations and long-term growth. Instead the Chamber proposed higher capital standards as an alternative means to achieve the intent of the Volcker Rule—more financial stability but without the regulatory complexity that can harm growth.

Today we have both—the Volcker Rule and higher capital standards. The Volcker Rule has imposed upon financial institutions a complex web of regulatory compliance. Basel III and systemic risk rules have created higher capital standards through opaque processes that make it difficult for the public to truly understand the strength of those firms. This has created incentives whereby firms do not provide the financing they have in the past.

The Volcker Rule has, in combination with other initiatives such as the Basel III Capital Accords, systemic risk rules, the foreign bank operation rules, risk retention rules and new money market fund rules harmed the ability of businesses to affordably raise the financial resources needed to operate on a daily basis and grow. Business financing is now more inefficient. Furthermore, the lack of economic analysis by the regulators in drafting the Volcker Rule is a *prima facie* instance of why evidentiary analysis, subject to public scrutiny and comment, is necessary for the drafting and implementation of regulations that may promote stability **and** growth.

It is important that policy makers review all of these rules individually and on a cumulative basis to determine the impact it has on stability and growth. Moreover, under President Trump's Executive Order on *Core Principles for Regulating the United States Financial System*, laws and guidance to determine if they promote the core principles of fostering growth and enabling U.S. competitiveness, the Volcker Rule should be thoroughly examined. Following such a review action should be taken to address the unintended consequences of the Volcker Rule by repealing it, or undertaking the efforts necessary to amend it. We believe that this hearing is an important first step in starting that process.

Background

Proprietary trading occurs when a financial firm buys and sells stocks, bonds, or other financial instruments, on its own trading account, with the purpose of profiting from market movements. It has been widely acknowledged, including by financial regulators themselves, that proprietary trading was not a cause of the 2008-2009 financial crisis. Nevertheless, some commentators, including former Federal Reserve Chair Paul Volcker were uneasy that banks were engaging in what they felt were not traditional banking activities that they felt might implicate the banks insured deposits. On January 21, 2010, President Barack Obama proposed a ban on proprietary trading and named it after former Federal Reserve Chairman Paul Volcker, its chief architect. The Obama Administration requested other nations to follow suit, which was universally rejected.[1] The Obama Administration supported the Rule's enactment despite the universally recognized fact that it would be exceedingly difficult to demarcate the lines between proprietary trading and other important bank activities like market making and underwriting.

The Volcker Rule was incorporated into the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) at the 11th hour. There was exactly one hearing on the Volcker Rule. During that hearing, in the Senate Banking Committee, serious doubts were voiced on a bipartisan basis as to how this Rule could be implemented. Mr. Volcker, one of the two witnesses at that hearing, was unable to articulate a method for delineating proprietary trading and other trading activities such as market making. Despite the lack of a hearing record establishing the need for the Rule, it was incorporated in the Senate version of the Dodd-Frank Act and became law.

[1] See E.U. Ministers to Resist Obama's Proposal for Banking Overhaul, *Bloomberg News,* Feb. 16, 2010.

Section 619 of the Dodd-Frank Act prohibits financial firms from engaging in proprietary trading and acquiring or retaining any ownership interest or sponsorship of a hedge fund or private equity fund. Additionally, Section 619 included exemptions for market-making and underwriting activities, risk-mitigating hedging and the sale or disposition of financial obligations of the United States.

On October 11, 2011, the Board of Governors of the Federal Reserve ("Federal Reserve"), Federal Deposit Insurance Corporation ("FDIC"), Securities and Exchange Commission ("SEC"), Office of the Comptroller of the Currency ("OCC") (also collectively as the "regulators") voted to release a joint Volcker Rule Proposal. This joint rulemaking, encompassing 298 pages and over 1,000 questions, was published in the *Federal Register* on November 7, 2011. The Commodity Futures Trading Commission ("CFTC") voted to release its version of the Volcker Rule Proposal on January 11, 2012, almost 90 days after the other regulators. The agencies approved and promulgated the Volcker Rule on December 9, 2013. The deadline for covered firms to comply with the Volcker Rule was July 21, 2015.

Since that time we have witnessed a tightening of debt markets whereby traditional buyers of debt and securities have failed to come forth.

Chamber Concerns with the Volcker Rule

The Chamber opposed the Volcker Rule at its inception because of its potential to negatively impact the market-making and underwriting activities needed for businesses to access liquid debt and equity markets. In the alternative the Chamber proposed higher capital standards as a means to promote financial stability if a covered financial institution chose to engage in proprietary trading.

Market makers play an essential role in financial markets, acting as a source of liquidity that keep markets vibrant and make investing feasible. As market makers, banks must hold inventories of the financial instruments in which they make markets. For example, corporations rely upon the "market making" activities of banks in order to secure affordable funding in the bond market. Without these "market making" activities, banks would be unable to underwrite these bonds. Thus, if banks can no longer hold inventory, it will be much more difficult for businesses to raise the amount of capital needed. Typically, banks will hold bonds in inventory that aren't sold in the marketplace on day one but later in the week. as under the Volcker Rule, however, this temporary inventory build-up is considered proprietary trading and therefore deprives issuers from raising the total amount of capital needed.

It is very difficult to distinguish between market making and proprietary trading without arbitrarily imposing a demarcation. The Volcker Rule significantly constrains their ability by dictating how banks should manage their inventory. This will reduce the depth and liquidity of our capital markets.

Bank trading activities are what create market liquidity and enable the market to provide an efficient clearing price. Without these activities, markets take a giant step backward toward individually negotiated bilateral 'deals'. Investors would no longer be willing to risk their capital in securities that in exigent circumstances would have to be sold at fire sale prices.

The Chamber submitted 14 letters[2] to the regulators and other agencies to raise our concerns with the Volcker Rule. Those concerns highlighted process irregularities especially the failure to conduct an economic analysis subject to public review and conduct, and sought post-promulgation action to address adverse consequences with trust preferred securities ("TRUUPS") and collateralized loan obligations ("CLOs"). In summary the Chamber expressed seven major concerns regarding the Volcker Rule implementation proposed by the regulators:

1) The Chamber was concerned how the Volcker Rule proposals were released and believed that comment process has been compromised as a result;[3]

2) The Chamber believed that serious issues and deficiencies exist with the economic and cost benefit analysis used by the regulators;[4]

3) In releasing the proposed Volcker Rule, regulators failed to take into consideration the adverse impacts the proposal will have on the ability of companies to raise capital;

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[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, November 25, 2013, December 4, 2013, January 14, 2014 and March 4, 2014 from the U.S. Chamber of Commerce to the regulators and FSOC.

[3] See October 11, 2011 letter from the CCMC to Treasury Secretary Timothy Geithner requesting that the Financial Stability Oversight Council use its authority to reconcile differences in the various Volcker Rule Proposals issued by the regulators; November 17, 2011 letter from CCMC to the regulators requesting a withdrawal and re-proposal of the Volcker Rule because of the failure of the CFTC to issue its proposed rule in conjunction with the other regulators.

[4] See December 15, 2011 letter from the CCMC to the regulators citing flaws with the cost benefit and economic analysis of the Volcker Rule Proposal, requesting that the proposal be submitted for enhanced economic analysis under OIRA review, that it be considered an economically significant rulemaking and that the regulators coordinate these efforts under Executive Orders 13563 and 13579. This letter also requested that the cumulative impact of other initiatives, such as Basel III, be taken into account when determining the economic impacts of the Volcker Rule Proposal.

4) The Volcker Rule will force commercial companies that own banks to build and maintain compliance programs though they have never engaged in proprietary trading;

5) The Volcker Rule creates ambiguity as to permissible market making and underwriting, thereby increasing risk and reducing liquidity for companies;

6) The Volcker Rule places the American economy at a competitive disadvantage and may in fact violate existing trade agreements; and

7) The Volcker Rule Proposal may endanger infrastructure projects and the businesses that work on them by impacting the ability of State and Municipal governments and agencies to raise capital.

Issues before the Promulgation of the Volcker Rule

a. Failure to Perform an Economic Analysis, Chamber Survey of Members

In proposing the Volcker Rule the regulators did not conduct an economic analysis. The OCC issued an economic analysis over 4 months *after* the Volcker Rule was promulgated, finding that the costs to 46 OCC regulated institutions could be as high as $4.3 billion dollars. Despite the Chamber's request, as is discussed in greater detail below, the regulators did not study the impacts of the Volcker Rule upon the broader business community nor was it treated as a major rulemaking decision.

An economic analysis of the costs and benefits of a proposed regulation on those affected by it is a critical tool in a regulator's tool box.[5] Cost-benefit analysis provides discipline to rulemaking so that rules are narrowly tailored to the problem they are designed to address. It also encourages the consideration of less costly alternative approaches.

An agency's failure to undertake economic analysis is more than a missed opportunity. The lack of adherence to express congressional instructions to consider certain costs and benefits is itself a violation of the Administrative Procedure Act, and it increases the possibility that the resulting rule will be found arbitrary and capricious.[6] For example, in 1996, Congress amended the Securities Exchange Act to require the SEC to consider a proposed rule's economic impact on efficiency,

[5] See Paul Rose and Christopher J. Walker, *The Importance of Cost-Benefit Analysis in Financial Regulation*, U.S. Chamber of Commerce (2013).
[6] See 5 U.S.C. § 706(2).

competition, and capital formation, in addition to its preexisting duty to consider the impact on investor protection.[7] In the years that followed, the SEC failed to take that mandate seriously, often claiming in a perfunctory way that it had "considered" the costs and benefits of a proposed rule and thus satisfied the statute even though it did not publish its analysis. It was not until a series of decisions by the United States Court of Appeals for the District of Columbia that the SEC began to undertake and publish its economic analysis when it proposes a rule.[8]

Despite the clear language of the Riegle Community Development and Regulatory Improvement Act of 1994 (the "Riegle Act"), the banking regulators did not perform an economic analysis of the Volcker Rule. Like the SEC, the Federal Banking Agencies are required to consider the costs and benefits of their proposed rules, albeit with respect to different metrics. Section 302 of the Riegle Act provides:

> [i]n determining the effective date and administrative compliance requirements for new regulations that impose additional reporting, disclosure, or other requirements on insured depository institutions, each Federal banking agency shall consider, consistent with the principles of safety and soundness and the public interest: (1) any administrative burdens that such regulations would place on depository institutions, including small depository institutions and customers of depository institutions; and (2) the benefits of such regulations.[9]

In implementing the Volcker Rule, which is designed to minimize the risks of proprietary trading on the federally insured deposits of a financial institutions, the banking regulators failed to undertake a legally mandated a cost-benefit analysis required of a proposed rule that may negatively impact the insured depository institutions that the rule is intended to protect.

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[7] 15 U.S.C. § 77b(b) ("Whenever pursuant to this subchapter the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation."); accord 15 U.S.C. § 78c(f) (same); 15 U.S.C. § 80a-2(c) (same); 15 U.S.C. § 80b-2(c) (same).
[8] See Bus. Roundtable v. SEC, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (chastising the SEC "for having failed once again—as it did most recently in American Equity Investment . . . and before that in Chamber of Commerce—adequately to assess the economic effects of a new rule"); Am. Equity Inv. Life Ins. Co. v. SEC, 613 F.3d 166 (D.C. Cir. 2010); Chamber of Commerce v. SEC, 412 F.3d 133 (D.C. Cir. 2005).
[9] 12 U.S.C. § 4802.

On December 15, 2011, the Chamber wrote to the regulators asking that a cost benefit analysis of the Volcker Rule be undertaken for public review and comment. The Chamber letter requested that the Volcker Rule:

- Be considered under the requirements of Executive Orders 13563 and 13579 in order to coordinate different requirements for economic analysis and finalization of rules;

- Be considered an economically significant rulemaking and the public provided with a qualitative and quantitative analysis of the impacts upon the economy as required by the Unfunded Mandates Reform Act of 1995 ("Unfunded Mandates Reform Act");

- Be subject to an enhanced Office of Information and Regulatory Affairs ("OIRA") regulatory review process; and

- Be considered in the context of other initiatives, such as Basel III, and other pertinent Dodd-Frank Act rulemakings, when determining the economic impacts

This letter also included a survey of Chamber members demonstrating the impacts of the proposed Volcker Rule upon non-financial businesses (see appendix A). The letter stated in part:

> While much of the focus of the Volcker Rule Proposal has been on financial institutions, there are significant costs to non-financial companies that have not been contemplated by the regulators. To illustrate these impacts, included as an appendix to this letter is a survey that uses 2010-2011 historic data, of select U.S. financing companies that provide services for non-financial businesses. It appears that the Volcker Rule will impose at least a five basis point increase in bid-ask spreads. In a confidential survey of five large U.S. borrowers, it estimates that under the Volcker Rule Proposal increase in the bid-ask spreads will be closer to 25-50 basis points increasing lending costs from between $742 million and $1.483 billion. In reviewing Volcker Rule impacts upon potential lending strategies for smaller less frequent borrowers, hypothetical scenarios suggest an increase in bid-ask spreads will be closer to 50 and 100

> basis points leading to increased lending costs of between $106 million and $211 million.
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> Also, in discussions with our membership it appears that there will be an impact upon switching transactions—the process whereby a financial institution buys back some of an issuer's older bonds as part of the process for a new issuance. For example, a 10 basis point increase caused by the Volcker Rule would increase the costs of switching transactions by $2.8 million per billion while a 50 basis point increase would drive up costs by nearly $14 million per billion.
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> Taken together, by extension, with $8 trillion of corporate debt outstanding and that approximately $7 trillion trades in a year, the incremental transaction costs for investors and financing costs for U.S. companies could total into the tens of billions of dollars.
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> These discussions with our members provide a snap shot of potential costs facing non-financial companies because of just one provision of the Volcker Rule Proposal. Other provisions will also markedly affect liquidity in the financial markets and will increase the costs associated with raising funds for both financial and non-financial firms throughout the economy.

Had the regulators conducted such an analysis and heeded the information the Chamber provided, some of the consequences of the Volcker Rule and other regulations currently interacting with it may have been avoided.

b. Chamber Study: Consequences of the Volcker Rule

In 2012 the Chamber also released a study, ***The Economic Consequences of the Volcker Rule*** ("Thakor study"), authored by Professor Anjan Thakor of the Olin School of Business, Washington University in St. Louis. (Attached as Appendix B). The study had four major findings:

1. The Volcker Rule will have a negative effect on market making and liquidity provisions for many securities.

2. The Volcker Rule will reduce network benefits of market making for financial institutions and businesses.

3. The Volcker Rule is likely to lead to higher costs of capital for businesses and potentially lead to lower capital investments by borrowers creating greater potential focus on short-term investments.

4. The Volcker Rule will make bank risk management less efficient, adversely impact the structure of financial institutions and harm the ability of businesses to raise capital.

The Thakor study found that financial firms were expected to retrench their market making activities away from smaller issuances. Businesses were expected to find a lower level of financial services activity and less liquidity. Market makers in securities operate in networks and any retrenchment will harm the general network benefits that all for the sale of securities. The reduction of those network benefits would be felt even if other non-Volcker regulated entities undertook market making activities. Reductions in liquidity and regulatory uncertainty will lead to higher costs of capital. Therefore, capital expenditures by businesses are of a shorter duration for a quicker payoff. Failure to have longer-term capital investment could lead to jobs loses. By artificially constraining the instruments a financial firm may hold, banks may have to accept more risk or operate with more cash. This will harm the diversification of financial firms and harm the ability of businesses to raise capital.

Unfortunately, many of the findings of the Thakor study are coming to fruition as the Volcker Rule has become fully operational.

Issues Arising Since the Promulgation of the Volcker Rule

In 2016, the Chamber released a survey of more than 300 corporate finance professionals. The report, ***Financing Growth: The Impact of Financial Regulation*** ("Survey"), (attached as Appendix C) found that 79% of treasurers felt that financial services regulation had impacted their business. One-third of treasurers expect the regulatory impact to worsen over the next three years. Treasurers believe that current and pending regulations will make their cash flow and liquidity operations more challenging. One third of these companies are being forced to take unanticipated steps in response to regulatory challenges and businesses are being forced to pass the impact of those costs on to their customers. This survey also

found that businesses had dramatically reduced the number of financial institutions they have used since 2013.

Treasurers stated that the regulations most negatively impacting them were the Volcker Rule, Basel III, SIFI regulations and SEC money market fund reforms.

In previous testimony the Chamber warned that one of the responses to the Volcker Rule would be an increase in the cash reserves that American businesses feel compelled to hold. American businesses have traditionally benefitted from liquid financial markets that enable them to put capital to work rather than holding excessive, dormant reserves. It has given American businesses a competitive advantage over their counterparts in the European Union. Recent regulatory developments have forced American businesses to take more of a European Union approach to finance. While U.S. cash reserves have not hit the ratios held by their European counterparts, U.S. corporate cash reserves rose by $100 billion since the Volcker Rule has been implemented. Cash at the S&P 500 has risen by over 50%, hitting all-time highs since the Dodd-Frank Act was passed.

Even though corporate bond issuances have increased, bond market liquidity has decreased with fewer dealers and less market making activity. This has led to unexplained stresses in the marketplace. A 2016 CFA Institute found that over a five year period liquidity in high yield investment grade corporate bonds had decreased, there were fewer dealers in the market place, there has been an increase in the time needed to execute a trade, trades are smaller in volume and there was an increase in unfilled orders. The CFA study also found that no liquidity issues existed for government bonds.

A 2016 Federal Reserve study (attached as Appendix D) looked at stress events in the corporate bond market. This study found that bond dealers regulated by the Volcker Rule had changed their behavior by decreasing their market making behavior. Because those dealers make up the preponderance of the marketplace, the Volcker Rule was found to have caused less liquid bond markets during times of stress.

Accordingly, businesses are forced to deal with a longer time horizon in meeting their needs and use a more inefficient marketplace which also creates the incentive to use alternative means of financing including the use of cash reserves. This also has an impact on the overall economy as less cash is deployed for productive purposes.

Many of these issues may have multiple causes, but the Volcker Rule is undoubtedly a contributory and exacerbating factor. In failing to use evidentiary tools

available to them to write the regulation, financial services regulators missed the opportunity to discover these problems before the rule was implemented. That is why the Chamber proposed using the conformance period as a time to "war game" these issues. Unfortunately, this was not done.

These impacts of the Volcker Rule as still working their way through the system and there is time to fix them.

Chamber Recommendations

The confluence of the Volcker Rule and other uncoordinated rule-makings such as those implementing Basel III, the risk retention provisions of the Dodd-Frank Act, systemic risk policies and money market reforms have created stress within the financing mechanisms for businesses. Financial firms now must deal with complex compliance structures that make the deployment of capital either more difficult or more expensive. For smaller companies, certain financial products or services may be unaffordable or altogether unavailable.

While the Chamber still believes that the Volcker Rule should be repealed, we also recognize that there are those who would like to see some form of the Volcker Rule remain in place. Additionally, we must have a better and clearer understanding of these major initiatives and how they interact with each other. Simply put, the Volcker Rule cannot be viewed in a vacuum; it must also be viewed in conjunction with other major rulemakings.

Accordingly, the Chamber recommends the following as a threshold to determine if an outright repeal of the Volcker Rule or a modification of it is the right course of action:

1. Conduct an economic analysis of the Volcker Rule to include the impacts on business financing as well as the consequences for financial institutions. It is important that the regulators understand how the Volcker Rule is affecting the customers of those financial firms. This analysis should also factor in the influences that the Volcker Rule may have on economic growth.

2. Conduct an analysis of major regulatory initiatives undertaken since the financial crisis to determine how they interact with each other and the economic consequences of those actions. This analysis should include, but not be limited, to: the Volcker Rule, risk retention rules, money market fund

regulations, Liquidity Coverage Ratio Rule, Net Stable Funding Ratio Rule, Total Loss Absorbency Coverage Rule, the Foreign Bank Operations Rule and capital rules and other rules promulgated under section 165 of the Dodd-Frank Act.

3. Following these studies, the regulators should report to Congress if the Volcker Rule and others should be repealed outright or amended. Regulators should then proceed with appropriate rulemaking to achieve those goals.

4. Congress and the Administration should take steps to ensure that banking regulators conduct an economic analysis with all rulemakings as required under the Riegle Act and the Administrative Procedures Act.

Conclusion

I appreciate the opportunity to appear before the subcommittee on such an important topic. The Volcker Rule, though well intentioned, has harmed the ability of non-financial businesses to operate and grow. These adverse impacts are exacerbated when combined with other initiatives. Additionally, the manner in which the Volcker Rule was written demonstrates flaws in the rule-writing process. Indeed this is an example of why a data driven, evidentiary based, transparent rule-writing process is needed to achieve the goals outlined by Congress in the least burdensome manner possible.

Our recommendations are common sense solutions to get the facts necessary to determine the path forward—repealing the Volcker Rule or at the very least a holistic and wholesale revision of the Volcker Rule as well as Basel III, the risk retention rules, systemic risk policies, the Foreign Bank Operations Rule and money market fund reforms. Such an exercise can develop policies that will promote both financial stability and economic growth. We look forward to working with all parties and stakeholder in achieving those goals.

I am delighted to discuss these issues further and answer any questions you may have.