HOUSE FINANCIAL SERVICES SUBCOMMITTEE HEARING

OVERVIEW

For questions on the note below, please contact Graham Harper or Daniel Austin at (202) 547-3035.

Today, the House Financial Services Subcommittee on Capital Markets, Securities, and Investment held a hearing entitled "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors, and Job Creation."

Key Takeaways

Several panelists agreed that the Volcker Rule has had an adverse impact on market liquidity, and it leads to higher capital costs for borrowers of all sizes.

According to Thomas Quaadman, U.S. Chamber of Commerce, the Volcker Rule has caused a shift to, and higher concentration in, U.S. Treasuries, which is creating more risk in that market.

Ronald Kruszewski, Stifel Corp., said that the Volcker Rule looks at every trade as proprietary unless proven otherwise, and it tries to get into the mind of a trader with the benefit of hindsight.

SUMMARY

Opening Statements and Testimony

Subcommittee Chairman Bill Huizenga (R-MI)

Framers of the Volcker Rule sought to exempt market-making activities, but the line between market making and banned proprietary trading is blurred.

Regulators have conceded that the Volcker Rule is impacting the liquidity of corporate debt.

The Volcker Rule has been a solution in search of problem, and it seeks to address activities that had nothing to do with the financial crisis. The Rule undermines financial stability rather than preserve it.

Subcommittee Ranking Member Carolyn Maloney (D-NY)

I support the Volcker Rule because it stands for an important principal that banks should not gamble with their clients' money, especially when there is a taxpayer backstop for losses they may incur.

Data from the Federal Reserve (Fed) has shown that risk levels on bank trading desks have been steady since the Volcker Rule took effect.

Banks are making most of their money on trading desks from market-making activities, not proprietary trading prohibited by the Rule.

Subcommittee Vice Chairman Randy Hultgren (R-IL)

The Dodd-Frank Act (DF) and the Volcker Rule were sold to protect taxpayers and investors when, in fact, they are doing the opposite. The Volcker Rule is hurting liquidity in corporate bond markets, which drives up the cost of capital. The Rule's compliance burdens also trickle down to community banks.

Mr. David Blass, General Counsel, Investment Company Institute (ICI)

The Volcker Rule was not directed at registered funds or at similar non-US funds. Unfortunately, the final regulations implementing the Volcker Rule resulted in many concerns for these funds and their investment advisers.

The five agencies responsible for implementing the Volcker Rule failed to provide a complete carve out for registered funds, which has resulted in these funds being treated like banking entities.

Mr. Marc Jarsulic, Vice President, Economic Policy, Center for American Progress

The connection between the decline in corporate bond inventories and the Volcker Rule is not very strong, and the dire consequences forecasted for the corporate bond market have not materialized.

Data on bid-ask spread, prices, and trade size do not indicate a deterioration of corporate bond liquidity.

The exit of large banks from proprietary trading has not had a measurable effect on corporate bond market liquidity, liquidity risk, or the ability of corporations to raise funds in the capital market.

Mr. Ronald J. Kruszewski, Chairman and CEO, Stifel Financial Corp., on behalf of SIFMA

It is my personal view that the Volcker Rule needs to be repealed, if not, it must be materially amended to avoid further damage to the markets my company serves.

The Volcker Rule has raised the cost of capital for businesses and encouraged pro-cyclical effects on liquidity in financial markets.

I do not believe the way to regulate risk, systemic or otherwise, is by inhibiting trading or traditional market making, which provides liquidity and depth to our capital markets, but rather through capital and liquidity rules.

Mr. Thomas Quaadman, Vice President, U.S. Chamber of Commerce

The Chamber opposed the Volcker Rule from the outset because of foreseeable negative consequences, and instead, we proposed higher capital standards as an alternative means to achieve the Volcker Rule's intent – today, we have both.

The Volcker Rule has imposed upon financial institutions a complex web of regulatory compliance, and its combination with Basel III and other rules has harmed the ability of businesses to affordably raise the financial resources needed to operate daily and grow.

Policy makers should thoroughly reexamine the Volcker Rule to repeal or amend it.

Professor Charles K. Whitehead, Cornell University

The Volcker Rule fails to reflect the change in how credit is provided today – moving from traditional banking to increasing bank participation in capital markets. This involves banks using their own balance sheets to buy and sell securities as part of a market-marking function. The Volcker Rule constrains this ability and adversely impacts the smooth operation of capital markets.

Changes in the financial markets spurred by the Volcker Rule still expose banks to the kinds of risks the Rule was intended to minimize and eliminate. The Rule should be replaced with a focus on risk-based capital requirements.

Discussion

Market-Making Activities

Maloney: Have banks pulled back from market making even during times of market stress? Why is it important that banks are getting most of their returns on new positions? *Jarsulic:* The data implies that market-making activity remains relatively stable during times of stress. Returns from new positions suggest that profits are being earned from fees and commissions.

Emmer (R-MN): Do you believe the economy is experiencing a capital shift to U.S. Treasuries because of regulations like the Volcker Rule? *Kruszewski:* There are many rules that need to be reexamined. Capital and liquidity rules were well thought out, but if companies cannot raise capital, they will not make investments and create jobs.

Market Liquidity and Fed Staff Report

Huizenga: Can you expand on the conclusions in the Fed's report about the Volcker Rule? *Whitehead:* The staff report focuses on relative liquidity. It takes a baseline on what liquidity might be before and after the Rule. The report finds that the Volcker Rule has had a substantial impact on bonds because when there needs to be liquidity in the markets, there is less of it.

Hultgren: Why are small and mid-sized issuers experiencing a disproportionately negative impact on their bonds? *Kruszewski:* For the debt markets, you need liquidity to efficiently price bonds, and the Volcker Rule has made that incredibly difficult. The ultimate cost to the economy is less liquidity and higher capital costs for smaller companies.

Himes (D-CT): How will we know when there is optimal market liquidity? *Kruszewski:* The Volcker Rule creates a blurred line between market marking and proprietary trading, which creates a disincentive for market making. The market will get to an optimal liquidity level, but not through regulation; *Whitehead:* It is not a question of absolute liquidity but relative liquidity. The Fed report shows a pullback in terms of liquidity during times of stress.

Poliquin (R-ME): Do you agree with the findings of the Fed report, and what are the implications if the report is accurate? *Kruszewski:* I agree with its finding, and to the extent the report is accurate, it means higher costs of capital. The Volcker Rule makes it difficult to make markets; *Quaadman:* Illiquidity is causing a drag on growth. As we are seeing more people get into the Treasury market, it is shifting risk to that market.

Volcker Rule Implementation and Effectiveness

Sherman (D-CA): Have the Volcker Rule's regulators coordinated effectively? *Kruszewski:* The regulators have different mandates and have good intentions; however, because of that, I am forced to adopt the viewpoint of the strictest regulator.

Lynch (D-MA): If the Volcker Rule is repealed, how much more difficult would it be to unwind a troubled bank? *Jarsulic:* The Volcker Rule was intended to be a preventative measure that lowers the difficulties caused by existing risk taking. The more you allow complex, loss-generating trading activity, the more it increases the difficulty in unwinding a failing institution.

Scott (D-GA): Did the Volcker Rule go too far or did it not do enough? *Jarsulic:* The Rule does not attempt to end risk-taking activities. It is intended to constrain high-risk activities, and it has done little harm on liquidity and market making; *Kruszewski:* If you want to limit bank risk, tell them not to make loans; the loan book was the root of the financial crisis. The Volcker Rule increases the cost to raise capital.

Volcker Rule Compliance

Huizenga: What does it cost to comply with the Volcker Rule? *Kruszewski:* The Rule hinders liquidity in capital markets. We make markets, and the Rule says that every trade is proprietary unless shown otherwise, resulting in higher costs of capital.

Hultgren: What compliance challenges has the Volcker Rule created? *Blass:* The lack of liquidity drives up costs on market participants; *Kruszewski:* The Rule makes a presumption that every trade is proprietary. Our compliance team tries to use the Rule's metrics, but they materially impact our ability to make markets.

Wagner (R-MO): How many institutions that did not engage in proprietary trading operations have been affected by the Rule? *Quaadman:* Many institutions, including regional banks, must create Volcker compliance programs. These compliance costs impact Main Street. The Rule has made it more difficult for smaller and mid-sized companies to raise the capital they need.

Hill (R-AR): Do you believe that the Volcker Rule compliance is too complex? *Kruszewski:* Any rule that tries to get into the mind of a trader is not workable. The Rule tries to evaluate what was in the mind of a trader with the benefit of hindsight.

Financial Crisis

MacArthur (R-NJ): Does the Volcker Rule address the fundamental cause of the financial crisis? *Blass, Kruszewski, Quaadman, and Whitehead:* No; *Jarsulic:* It addresses a part of the cause.

Hollingsworth (R-IN): In your opinion, what caused the financial crisis? *Kruszewski:* It was a combination of bad loans, high leverage ratios, mortgage-backed security ratings, and more. When you have an economic crisis, the financial industry will be in the middle.

Fiduciary Rule

Wagner: What is the effect of a lack of certainty on delay of the Department of Labor's (DOL) fiduciary rule and its impact on customers? *Kruszewski:* There is a lot of confusion regarding the DOL fiduciary rule and its implementation date. The fiduciary rule will lead to our clients losing advice or being moved to a fee-based compensation scheme; it significantly impacts small savers.