THE IMPACT OF THE VOLCKER RULE ON JOB CREATORS, PART I

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

SECOND SESSION

JANUARY 15, 2014

Printed for the use of the Committee on Financial Services

Serial No. 113–59

U.S. GOVERNMENT PRINTING OFFICE

88–521 PDF WASHINGTON : 2014

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

JEB HENSARLING, Texas, *Chairman*

GARY G. MILLER, California, *Vice Chairman*
SPENCER BACHUS, Alabama, *Chairman Emeritus*
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
SHELLEY MOORE CAPITO, West Virginia
SCOTT GARRETT, New Jersey
RANDY NEUGEBAUER, Texas
PATRICK T. MCHENRY, North Carolina
JOHN CAMPBELL, California
MICHELE BACHMANN, Minnesota
KEVIN McCARTHY, California
STEVAN PEARCE, New Mexico
BILL POSEY, Florida
MICHAEL G. FITZPATRICK, Pennsylvania
LYNN A. WESTMORELAND, Georgia
BLAINE LUETKEMEYER, Missouri
BILL HUIZENGA, Michigan
SEAN P. DUFFY, Wisconsin
ROBERT HURT, Virginia
MICHAEL G. GRIMM, New York
STEVE STIVERS, Ohio
STEPHEN LEE FINCHER, Tennessee
MARLIN A. STUTZMAN, Indiana
MICK MULVANEY, South Carolina
RANDY HULTGREN, Illinois
DENNIS A. ROSS, Florida
ROBERT PITTENGER, North Carolina
ANN WAGNER, Missouri
ANDY BARR, Kentucky
TOM COTTON, Arkansas
KEITH J. ROTHFUS, Pennsylvania

MAXINE WATERS, California, *Ranking Member*
CAROLYN B. MALONEY, New York
NYDIA M. VELÁZQUEZ, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN MCCARTHY, New York
STEPHEN F. LYNCH, Massachusetts
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
GWEN MOORE, Wisconsin
KEITH ELLISON, Minnesota
ED PERLMUTTER, Colorado
JAMES A. HIMES, Connecticut
GARY C. PETERS, Michigan
JOHN C. CARNEY, JR., Delaware
TERRI A. SEWELL, Alabama
BILL FOSTER, Illinois
DANIEL T. KILDEE, Michigan
PATRICK MURPHY, Florida
JOHN K. DELANEY, Maryland
KYRSTEN SINEMA, Arizona
JOYCE BEATTY, Ohio
DENNY HECK, Washington

SHANNON MCGAHN, *Staff Director*
JAMES H. CLINGER, *Chief Counsel*

CONTENTS

THE IMPACT OF THE VOLCKER RULE ON JOB CREATORS, PART I

Wednesday, January 15, 2014

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Members present: Representatives Hensarling, Bachus, Royce, Capito, Garrett, Neugebauer, McHenry, Campbell, Pearce, Posey, Luetkemeyer, Huizenga, Duffy, Hurt, Grimm, Stivers, Fincher, Stutzman, Mulvaney, Hultgren, Ross, Pittenger, Wagner, Barr, Cotton, Rothfus; Waters, Maloney, Velazquez, Sherman, Meeks, Capuano, Lynch, Scott, Green, Moore, Ellison, Perlmutter, Himes, Carney, Sewell, Foster, Kildee, Murphy, Delaney, Sinema, Beatty, and Heck.

Chairman HENSARLING. The committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time.

The hearing today is entitled, "The Impact of the Volcker Rule on Job Creators, Part I." I wish to alert all Members that we have already scheduled Part II of the hearing on this topic on February 5th. It will be with regulators who promulgated the rule.

I will now recognize myself for 5 minutes to give an opening statement.

As a Nation, we just marked the 50th anniversary of the War on Poverty, tragically a failure on more than one level. To win, we need more jobs, which means we need less Volcker.

In 2 weeks, the President will deliver his sixth State of the Union Address. Early in his term, he received from the Democratic Congress every single major policy initiative he asked for: the stimulus; Obamacare; and the Dodd-Frank Act from which the Volcker Rule arises. He got it all. The results of this are an unprecedented spending spree and a regulatory tsunami, the effects of which are now apparent to all. We have become a part-time worker, unemployment check, food stamp, insolvent Nation with few opportunities and even fewer hopes for the truly needy amongst us.

The President's policies have exacerbated the very income inequality that he now decries. Under President Obama, 6.7 million more Americans have fallen into poverty. America is suffering under the highest poverty rate in a generation, median household income has fallen each year that he has been in office, and a record 47 million Americans receive food stamps.

With a record like this when it comes to the War on Poverty, some Americans may just wonder which side the President is on. And if history proves a reliable guide, during the State of the Union Address the President will offer more of the same: more food stamps; more unemployment checks; and more minimum wages, all neatly wrapped in the politics of division, redistribution, and envy. That is not right, that is not fair, and it is not what hard-working, struggling families in the Fifth District of Texas are looking for.

Joseph of Mabank, Texas, told me, "I am a disabled veteran and have been without work for over a year. All I want is to have a good-paying job and let the rest come as it happens."

Claudia from Mineola, in my district, was laid off for 9 months. She finally found a job that paid her 25 percent less and added 60 miles to her daily commute. She said, "I don't have the American taxpayers bailing me out or lending me money that I can't pay back."

It is for Joseph and Claudia and all of the unemployed and underemployed Americans that we have to fight, and you cannot win a war on poverty as long as you are conducting a war on jobs.

And that brings us to the subject of today's hearing, the 900-plus page compound, complex, confounding, confusing, convoluted Volcker Rule. Like most of the other 400-plus rules of Dodd-Frank, the Volcker Rule is aimed at Wall Street but it hits Main Street, and regrettably the poor and downtrodden amongst us become collateral damage.

First, Volcker is a solution in search of a problem. It is important to note that of the roughly 450 financial institutions which failed during or as a result of the crisis, not a single one failed because of proprietary trading. In fact, financial institutions which varied their revenue stream were better able to weather the storm, and thus keep lending, and thus support jobs. Instead, these bank failures have come largely from concentration in lending in the subprime and sovereign debt markets. And who steered these financial institutions into these markets? Sadly, but not surprisingly, it was Washington, and they are still at it.

At one of our earlier hearings on the Volcker Rule, a Democratic witness claimed the burdens placed on our economy by Volcker were no big deal because "it only applies to just a few banks." If thousands upon thousands of negative comments the regulators received in response to their proposal from community and regional banks, and businesses both big and small, do not lay that claim to rest, I believe today's hearing will.

The statement that Volcker only applies to just a few banks ranks right up there with, "If you like your health care plan, you can keep it." For if it were true that the 900-plus page regulation applies to just a few banks, why did the Public Utility Commission in my native Texas warn that my constituents could experience higher and more volatile electricity prices because of Volcker? That is higher electricity prices for the poor. And why will the Volcker regulation, as one study points out, take $800 billion out of the productive economy and sideline it? That is the equivalent of taking more than $6,900 out of every American household's paycheck.

As a Nation, we can do better. We must do better. The path out of poverty is not food stamps or unemployment checks, it is not the culture of victimization or the politics of envy, and it is certainly not the Volcker Rule, which will harm many of our capital markets, equity joint ventures (EJVs), collateralized debt obligations (CDOs), venture capital, and especially the CLO market.

The path out of poverty is well-known. It has everything to do with strong, faith-based institutions; strong families; strong communities of support; strong schools designed for students, not teachers' unions; and small businesses and entrepreneurship with access to affordable and available capital so there are boundless job opportunities for all, especially the poor, and as chairman of this committee, this is what we will work toward.

The Chair now recognizes the ranking member, Ms. Waters, for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman. Normally, I would thank you for holding a hearing, but it looks as if this hearing that you have called is more focused on an attack on the President and the Administration than really dealing with the Volcker Rule, so I am going to try and direct my comments to the Volcker Rule.

It has been more than 5 years since the beginning of the financial crisis which resulted in the largest destruction of wealth in a generation. And while many observers still disagree about its central cause, we know that proprietary trading played a significant role. Such trading has indeed produced tremendous profits for some of our largest financial firms, but it also contributed to losses during the height of the crisis. In fact, one academic study estimated that by mid-April of 2008, banks had lost roughly $230 billion on certain proprietary holdings, which regulators and other interested parties had believed were simply inventories of assets held to facilitate client trading.

In the wake of these devastating losses, taxpayers stepped in to staunch the bleeding, and Congress took action to ensure that such an emergency would never happen again, enacting comprehensive legislation to address the many causes of the crisis, from the bad loans at the heart of the collapse, to the exotic securitizations that drove the demand for predatory mortgages, to the opaque derivatives markets that created tremendous interconnectedness and risk in our financial system.

A key part of Wall Street reform is the Volcker Rule. If properly implemented, the rule will provide that banks insured by taxpayer dollars can no longer engage in proprietary trading or investments in risky vehicles like hedge funds. The concept of the rule is simple: Loan-making, deposit-taking banks should not be engaged in risky speculative activity on the backs of the American taxpayers.

Many observers of our financial system agree with this. Standard & Poor's has pointed out that, "the implementation of the Volcker Rule could have favorable implications for the credit profiles of some of the largest U.S. banks such as reducing trading portfolio risk." John Reed, the former Citigroup chairman, notes that, "A strong Volcker Rule is one of the most important provisions to prevent too-big-to-fail financial institutions, stop conflicts of interest, and support credit in our economy." And even Chairman Hensarling has stated to The Wall Street Journal that, "We have to do a better job ring-fencing, fire-walling, whatever metaphor you want to use, between an inspired depository institution and a noninsured investment bank."

In the face of this statutory directive to implement Volcker, our regulators have undertaken their tremendous task of wading through 18,000 comments and have engaged with stakeholders during dozens upon dozens of meetings. We see the European Union potentially moving forward with a similar effort, and the United Kingdom has passed legislation implementing a similar measure known as the Vickers Report. All of these actions should be applauded.

At the same time, I understand that regulators are working diligently to address some issues related to the rule that have come up in the last month, including the issue related to collateralized debt obligations backed by trust-preferred securities. Most of the Democratic members of this committee urge regulators to provide an exemption for banks that would be consistent with their treatment under the Wall Street Reform Act. I appreciate the regulators' responsiveness on this point and believe their recent interim rule has provided important relief to community banks.

Mr. Chairman, the Volcker Rule will ensure Federal dollars are no longer used to protect losses from risky trading. Doing so will protect the U.S. economy from suffering another debilitating financial crisis, and will ensure taxpayers are never again asked to rescue failed financial firms. And now that we have the rule's framework in place, I look forward to conducting real oversight and ensuring that our regulators are faithfully enforcing this provision which will be central to the success of the Wall Street Reform Act.

I thank you, and I yield back the balance of my time.

Chairman HENSARLING. The Chair now recognizes the gentlelady from West Virginia, the Chair of our Financial Institutions Subcommittee, Mrs. Capito, for 2 minutes.

Mrs. CAPITO. Thank you. I would like to thank the chairman for yielding me time and for having this hearing.

Two years ago, Mr. Garrett and I had a joint hearing talking about the challenges of the implementation of the Volcker Rule, so this is our third hearing. And just over a month ago, five agencies charged with writing this rule released their final version. Throughout the discussion, the focus has been to limit certain activities at large complex financial institutions. However, within hours of the release of the final rule, it was apparent that financial institutions and small businesses on Main Street would be significantly affected by the rule. The ranking member talked about this issue.

Three weeks ago, we learned that financial institutions which held CDOs backed by trust-preferred securities could be required to take an immediate writedown on these investments in order to comply with accounting principles. These potential losses facing institutions could have been very significant, and especially punitive for smaller institutions. It is important to note when the rule was written and published in December, or before the final rule was published, this issue was not even a part of the rule to where they could have had any comment or any public weigh-in on this rule so we could have averted this.

To me, this just shows you that the uncertainty surrounding the rollout of the rule is a product of placing artificial deadlines on the agencies for writing these rules. There clearly was miscommunication between the agencies, which brought about these unintended consequences. In fact, the treatment of CDOs backed by trust-preferreds was not even mentioned, as I said, and the end result sent hundreds of banks scrambling with a very tight deadline.

Members of both the House and the Senate, on both sides of the aisle, have expressed concern in the last few weeks, and I would like to thank the agencies for releasing an interim rule last night that provides clarity for how financial institutions will treat their investments and collateralize debts backed by trust preferred securities (TruPS). Their interim final rule is similar to legislation which I authored with Chairman Hensarling last week.

I look forward to hearing the comments, and I want to thank the witnesses for coming today. Thank you.

Chairman HENSARLING. The Chair now recognizes the gentlelady from New York, the ranking member of our Capital Markets Subcommittee, Mrs. Maloney, for 2 minutes.

Mrs. MALONEY. This is an important hearing on the Volcker Rule, which is named after former Federal Reserve Chair Paul Volcker, a great New Yorker. Chairman Volcker initially proposed this ban on proprietary trading because he believes that banks which receive Federal deposit insurance should be serving their customers and not making risky bets for their own accounts. This was a sensible proposal because customer deposits would be at risk if the bets went wrong.

The GAO report on proprietary trading calls proprietary trading a leading cause of the financial crisis, which, according to their report, took over $9 trillion of assets from our country and affected $12 trillion of economic growth that would have happened without the crisis.

The road that this rule took from an idea in Chairman Volcker's head to the final rule was long and difficult. It involved 5 different Federal agencies plus an oversight council, over 18,000 comment letters, multiple hearings in Congress, and now a 71-page final rule with 892 pages of explanatory notes. And there is still a great deal of work that needs to be done. Bank examiners will have to work with the banks to develop the detailed compliance and data reporting programs for which the rule calls.

So as we press ahead with the implementation phase, I would urge the regulators to stay committed to a data-driven approach. If the data shows that there are unintended consequences, or if liquidity is seriously impaired, then the regulators need to be willing to make tweaks to the rule to get the desired outcome. At the same time, if the data shows that banks are evading the Volcker Rule, then the regulators need to be equally willing to exercise their authority to crack down. The Volcker Rule is the law of the land now, so it is important that we get it right. Thank you.

Chairman HENSARLING. The Chair now recognizes the gentleman from New Jersey, the Chair of our Capital Markets Subcommittee, Mr. Garrett, for 2 minutes.

Mr. GARRETT. Thank you, Mr. Chairman.

Now, 3½ years after its enactment, the regulatory tsunami of Dodd-Frank continues unabated. We should all know by now that Dodd-Frank solved few, if any, of the problems that caused the financial crisis. For example, instead of actually solving too-big-to-fail, Dodd-Frank actually codified it. Instead of taking the time to solve the problems that caused the financial crisis such as the over-subsidization of the U.S. housing market by the Federal Government, the failed prudential regulation, and failed monetary policy by the Federal Reserve, Congress instead created a solution in search of a problem, and exhibit A is the Volcker Rule.

As critics have pointed out, the Volcker Rule has the potential to significantly crimp the legitimate market-making activities to the detriment of the U.S. financial markets and disrupt the corporate bond markets, reduce liquidity, drive up borrowing costs, and harm investors.

Unfortunately, it is difficult to know exactly how detrimental this rule may be, in part because it lacks clear rules of the road in favor of regulatory discretion, and in part because the regulators failed to support it with an adequate economic analysis. And this is to say nothing of how the rule will be coherently implemented and enforced by five separate regulators, each with different mandates and authorities.

By the way, this is just one rule. We must also consider a number of other rules that haven't been finalized yet, for example, the supplemental leverage rule, the liquidity coverage rule, the risk-based capital rule, the counterparty credit limits rule, the net stable funding rule, the credit risk retention rule, the rules for foreign banking organizations, the rules on security-financing transactions, the pay ratio rule, the derivative cross-border rules, the SEF rule, the clearing rules, the position limit rules, the OTC market rules— I could go on, but I don't have the time.

So what is the cumulative effect of all these rules together on the U.S. economy and American businesses? Mr. Chairman, similar to the Volcker Rule, no one really knows, especially the regulators, all of whom continue to thumb their nose at the law and continue to not perform the appropriate economic analysis.

I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from New York, the ranking member of our Financial Institutions Subcommittee, Mr. Meeks, for 1½ minutes.

Mr. MEEKS. Thank you, Mr. Chairman.

As we sit here today to discuss an important milestone in our efforts to reform our banking institutions and financial system, the adoption of final rules to ban banking institutions from engaging in proprietary trading and investments in private equity funds and other covered funds is a central piece of our new financial order that we passed and enacted almost 4 years ago.

Just yesterday, the Subcommittee on Financial Institutions held a hearing on the QM rules which became effective just last week, another major piece of our new financial order. I am very pleased to see that we have finally made progress through the effective implementation of these two major financial reforms, which both in their own way ensure that the clients', depositors' or mortgagors' interests are preserved and protected.

The Volcker Rule will finally settle a long-known problem in our banking system. Clients seeking investment advice or assistance from their bankers will know for sure that their bank's own proprietary trading will no longer be able to conflict with their own interests. We have observed too many cases here and abroad where aggressive traders chasing the next big bonus abused this privileged relationship, passing their own toxic investment to other clients and benefiting from it at the same time. Moreover, we have seen too many big banks suffer volatile revenue, and even some go under because of their engagement in risky trading activities which can lead to massive losses and insolvency.

I join with the ranking member to make sure the regulators help with CDOs, and I also ask the regulators to look to clear up some of the rules with reference to CLOs. I think those things would help us as we move forward, and I very much look forward to hearing the testimony of the witnesses.

Chairman HENSARLING. The Chair now recognizes the chairman emeritus of the committee, the gentleman from Alabama, Mr. Bachus, for 1 minute.

Mr. BACHUS. Thank you, Mr. Chairman.

Mr. Chairman, Mrs. Maloney said that the Volcker Rule is the law of the land. It actually is not the law of the land. It takes effect on April Fool's Day. And what is the law of the land? We really don't know.

We started with a 37-word short paragraph in an 846-page bill, Dodd-Frank, which said you can make markets, but you can't do proprietary trading. That sounds pretty easy, doesn't it? Now we have over 900 pages of trying to distinguish between the two. Often, they are indistinguishable. But I think Federal Reserve Governor Daniel Tarullo told us what it is. He said a specific trade may either be permissible or impermissible, depending on the context and the circumstances under which the trade was made. That sounds like what Madam Pelosi said about Obamacare, "We will have to pass the bill to find out what is in it." And we see how that has worked out. The Weekly Standard has this train wreck on it which is Obamacare. That was actually in July.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from Ohio for 1 minute.

Mrs. BEATTY. Thank you, Mr. Chairman, and Ranking Member Waters.

We have certainly heard a lot about the history and opinionated views on that short section of Dodd-Frank, Section 6119. So, let's fast-forward to where we are now on the rule: 18,000 comments, a final rule, and nearly 3 years later to where we are today. Though the regulators wisely developed a lengthy timetable for implementation, we are currently on the verge of strengthening our banking system, and improving our financial markets, and are one step closer to eliminating the idea that there are certain institutions that are too-big-to-fail.

With respect to the TruPS, the CDO issue, the joint agency fix issued last night seems to me to strike the right balance between exempting only community banks versus exempting all banks. The regulators have done so by creatively constructing the exemption not on the basis of the size of the bank holding the TruPS, but instead on the basis of the size of the banks issuing the TruPS.

Thank you, and I yield back.

Chairman HENSARLING. The Chair now recognizes the gentleman from Colorado, Mr. Perlmutter, for 30 seconds.

Mr. PERLMUTTER. Thanks, Mr. Chairman.

In Dodd-Frank we tried to, by an amendment, return to the separation of commercial banks from investment banks and insurance companies. That amendment was defeated. An objection and prohibition against proprietary trading by banks was then passed by this House, was modified, and became what is now the Volcker Rule to try to rein in the Wild West approach that caused our economy to crash in 2008.

So I take the words of Mr. Garrett and the chairman to heart that that is what they believe, but without something like the Volcker Rule and Dodd-Frank, this economy would be in the tank for years and years to come.

With that, I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

Today, we welcome five witnesses. First, our former colleague, Ken Bentsen, Jr., is president and chief executive officer of the Securities Industry and Financial Markets Association. Mr. Bentsen served in this House as a Democratic Member from my native Texas from 1995 to 2003. We welcome him back today.

Charles Funk is the president and chief executive officer of MidWest One Bank in Iowa City, Iowa. He previously served as president, chief investment officer, and senior vice president of a regional Midwestern bank. He currently serves on the American Bankers Association's Board of Directors.

Professor Simon Johnson is the Ronald Kurtz Professor of Entrepreneurship at MIT's Sloan School of Management. He is also a senior fellow at the Peterson Institute for International Economics. Professor Johnson's opinions on a variety of financial subjects regularly appear in mainstream news and Internet publications. He earned his Ph.D. in economics from MIT.

Elliot Ganz is the executive vice president and general counsel of the Loan Syndications and Trading Association, where he is responsible for managing LSTA's legal and regulatory affairs and its market practice and standardization initiatives. He holds a law degree from NYU.

Last but not least, David Robertson is a partner and director of Treasury Strategies, a consulting firm that provides advice to corporate and other professional treasurers. As the leader of financial services practices, Mr. Robertson works with global and regional banks, payment and liquidity providers, and regulators.

Each of you gentleman will be recognized for 5 minutes to give an oral presentation of your testimony. Hopefully, each of you is familiar with our lighting system of green, yellow, and red. And please remember to pull the microphones very, very close to your mouth when you speak. And without objection, each of your written statements will be made a part of the record.

Mr. Bentsen, you are now recognized for 5 minutes.

STATEMENT OF THE HONORABLE KENNETH E. BENTSEN, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. BENTSEN. Thank you. Chairman Hensarling, Ranking Member Waters, and members of the committee, thank you for providing me the opportunity to testify.

SIFMA represents a broad range of financial services firms active in the capital markets. Those who have grappled with the Volcker Rule at any level deeper than that of a media sound bite know that balancing the statutory mandate to both prohibit and permit certain activities and investments in a way that does not harm the capital markets and the companies, governments, and investors who rely on those markets is a very serious business and horribly complex. It is no wonder that the proposed rule posed over 1,300 questions and that the final rule runs 71 pages with nearly 900 pages of comments.

SIFMA and our members still believe the Volcker Rule is a policy response in search of a problem, and we remind the committee that no other country has adopted a corollary to it. It is, however, the law of the land, and our members are committed to complying fully with the rule.

As the rule comes into full force, it will affect many markets and products. Our preliminary assessment shows that beyond the impact that will result from the significant new compliance costs, the rule will also affect venture capital, equity joint ventures and acquisition vehicles, municipal financing via tender option bonds, asset-backed commercial paper, commercial loans and lending via CLOs and CDOs and other securitizations, and trading of foreign sovereign debts.

I would note that the relief issued yesterday by the agencies is certainly welcome relief for some, but it has not resolved the very serious issues regarding collateralized loan obligations that, left unresolved, will affect the cost of credit to Main Street businesses which benefit from that market.

Our members are also beginning to focus on their conformance plans and the intense compliance programs that the final regulation requires. But this work is not the end of the story. Just as the financial sector will have to develop and implement conformance plans, compliance programs, internal controls, independent testing and auditing, training and records and retention, so too will regulators have more work to do to explain what certain provisions mean and how they are intended to work.

Most importantly, just as five regulators ultimately coordinated to write one rule, they must now coordinate and be consistent in their interpretation, examination, supervision, and enforcement. A lack of consistency will not only create unnecessary and costly confusion; it will undermine the rule itself.

The lack of an explicit mechanism or process for ongoing regulatory coordination and resolution of differences has emerged as our member firms' greatest initial concern. Without it, there is a significant risk that agencies will have differing interpretations of similar provisions or activities covered by the rule, resulting in inconsistencies in their examination, supervision, and enforcement.

This will undoubtedly raise additional compliance burdens that will cause firms to needlessly restrict activities which are otherwise explicitly allowed, the net effect of which being the restriction of capital committed to certain markets and the resultant reduction in liquidity.

What happens if the SEC and its examiners takes one point of view for the broker-dealer while the OCC takes another point of view for the national bank of the same affiliated institution? Add the complexity of the CFTC reviewing the activities of the national bank for its registered swap dealer. What if the FDIC takes one view for nonmember banks and the Federal Reserve another for member banks?

This concern is significant as we move deeper into firms planning for conformance, implementation, and development of compliance regimes. For example, a number of the largest institutions must begin tracking certain metrics of their activities by July of this year. Our members have concerns as to how each agency will interpret the metrics described in the rule, and how and to which agency they will be reporting. Differences in approach across agencies would make the metrics reporting almost impossible, especially given the fact that metrics reporting will have to be programmed into the computer systems. Inconsistency in approach could also undermine the transparency and comparability of the information from institution to institution, thus making the information far less valuable.

Regrettably, the final regulations are completely silent on regulatory coordination. The final Volcker Rule does not address how interpretations in guidance will be meted out, how examinations will be coordinated in form and result, how the agencies will work together on supervision in any respect, or how various cross-border compliance and coordination issues will be addressed.

We believe that the immediate goal should be for the agencies to articulate a transparent and consistent roadmap for coordination on both near-time interpretive guidance and the long-term examination and supervisory framework, including realistic goals on quantitative reporting which prioritize utility of data. Further, we believe that it is incumbent upon the FSOC to exercise its authority to coordinate supervisory activities with respect to the rule as Congress provided for. Additionally, we strongly believe that there is an oversight role for Congress to play in ensuring such coordination and the consistent application of the rule, beginning with this hearing today.

In conclusion, I wish to stress that there remain many outstanding questions as to how the Volcker Rule will be implemented and enforced. There is a strong likelihood that significant issues may arise in the coming weeks and months that are simply not on our radar screen today. The Volcker Rule is that complex. Failure to adequately address these issues when they arise could result in more compliance burdens that would undermine the activities beneficial to the economy. We look forward to working with Congress, our regulators and other market participants to ensure that the implementation of the Volcker Rule is not disruptive to the capital markets and the job creators they support.

With that, I look forward to answering your questions.

[The prepared statement of Mr. Bentsen can be found on page 66 of the appendix.]

Chairman HENSARLING. Mr. Funk, you are now recognized for 5 minutes.

STATEMENT OF CHARLES FUNK, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MIDWEST ONE FINANCIAL GROUP, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION (ABA)

Mr. FUNK. Chairman Hensarling, Ranking Member Waters, my name is Charlie Funk, and I am president and CEO of MidWest One Bank and MidWest One Financial Group, a $1.7 billion community bank headquartered in Iowa City, Iowa. I appreciate the opportunity to be here on behalf of the ABA to discuss the unintended consequences of the recently finalized Volcker Rule.

Let me begin by thanking you, Chairman Hensarling, Ranking Member Waters, Subcommittee Chairwoman Capito, and many other members of this committee for the recent engagement with the regulators on the unnecessary and potentially significant losses on collateralized debt obligations secured primarily by trust-preferred securities.

I would also like to thank Chairman Hensarling and Chairwoman Capito for introducing H.R. 3819, which ABA strongly supported, to provide relief to banks like mine which would suffer considerable losses under the agency's rule. Your many voices on the issue and sense of urgency to address unintended negative consequences helped move the process forward to find a satisfactory solution. This solution will help many community banks like mine and, more importantly, the customers and communities we serve.

ABA also applauds the regulatory agencies for moving quickly to find a resolution to the problem. This is a very good example of how the agencies should act when problems in a rulemaking arise. With such a complicated rulemaking as the implementation of the Volcker Rule, which totaled nearly 1,000 pages, inevitably there will be problems that were not anticipated. If the regulators had not acted, the immediate cost to my bank would have been over $1 million. For the industry it would have been at least $600 million, with the impact on communities many multiples of that.

Although this specific issue now appears to be resolved, it is indicative of a much broader problem. Just as the Dodd-Frank Act is the law of the land, so is the Volcker Rule. While we have concerns with the aspects of the rule, our focus now is to ensure that it be applied in a way consistent with its original intention to address the systemic risk, not impose costs on banks like mine unrelated to systemic issues.

We are very concerned that the agency's rule is so broad that it has consequences far beyond what Congress intended and will hurt legitimate investments that not only are safe and sound choices for banks, but that support the credit availability and financial service needs of our customers. As a result of the agency's broad definition, many investments made by banks of all sizes in CDOs, CLOs, collateralized mortgage obligations, and venture capital investments will no longer be allowed. These pooled products are essential to ensuring credit reaches where it is needed most, as well as helping banks manage and mitigate risk by diversifying their exposure to borrowers. These are traditional banking assets, not the trading instruments that Volcker was designed to capture.

There is a real irony in the fact that a rule designed to prevent banks from taking losses on short-term assets will instead force banks to sell long-term investments early, often resulting in a market loss. The loss to banks will be the gain of the less regulated nonbank sector which was complicit in the problems that led to the financial crisis as they will have an opportunity to buy assets with recovering values at discount prices.

Finally, the rule also results in a compliance burden for community banks despite agency statements to the contrary. It is possible that community banks will need to put in place compliance programs to ensure they do not inadvertently violate the Volcker Rule. These compliance programs are costly and time-consuming, taking away valuable resources that could otherwise be used to serve local communities.

In conclusion, the Volcker Rule should not impair traditional banking services that allow banks to meet the needs of their customers, nor impose unnecessary costs on any bank, particularly regional and community banks where no argument of systemic risk can be justified. Congress should be vigilant in ensuring that the rules are focused on the original intent to reduce systemic risk and not used to hinder the traditional business of banking, which is providing credit to customers.

Thank you for allowing me to appear before you today, and I would be happy to answer questions during that time.

[The prepared statement of Mr. Funk can be found on page 86 of the appendix.]

Chairman HENSARLING. Professor Johnson, you are now recognized for 5 minutes.

STATEMENT OF SIMON JOHNSON, RONALD KURTZ PROFESSOR OF ENTREPRENEURSHIP, MIT SLOAN SCHOOL OF MANAGEMENT

Mr. JOHNSON. Thank you, Mr. Chairman.

I completely agree with what Mr. Funk said, which is that the original intent of the Volcker Rule is to reduce systemic risk. I am sure you all remember vividly the fall of 2008 when very large banks and quasi-banks such as Citigroup, Morgan Stanley, Merrill Lynch, and others suffered very large losses because they made big proprietary bets. They engaged in excessive risk-taking. They didn't always call it proprietary trading, it is true. That perhaps reflected their misunderstanding of the risks in which they were engaged. And in September 2008, the Bush Administration came to Congress asking for a bailout, not, I think, particularly a bailout targeted at community banks, but a bailout targeted at some of the largest firms on Wall Street.

Chairman Paul Volcker, I believe, correctly articulated that we should limit the amount of risk-taking that can be taken by what are now bank holding companies, very large bank holding companies. I would stress the largest six or the largest eight is the focus of attention here. They have FDIC guarantees on their deposits. They also have some degree of subsidy because they are perceived by many in the credit markets to be too-big-to-fail. They should therefore, as a matter of general prudence and a matter of systemic risk reduction, be limited in the kind of proprietary bets they can take, and that is exactly what the Volcker Rule was designed to do. It has gone through a very long, involved process with an enormous amount of industry input, and there is now a good chance that the rule as proposed and as amended, including yesterday, will serve that purpose.

I think, Mr. Chairman, you are exactly right to focus on the job creators, on what has happened to jobs in the United States. I am the former chief economist of the International Monetary Fund, among other things. I worked on financial crises around the world for more than 25 years. Unfortunately, the experience we have had in this country over the past half decade is very typical of what we have seen in lots of different countries and situations. When the financial system blows up, and when the biggest parts of any financial system get it wrong in terms of understanding the risks, or in terms of managing their positions, sometimes we call that proprietary trading, and sometimes it has different names. It is the same problem almost everywhere.

And the damage, you are absolutely right, Mr. Chairman, is on the companies, it is on the community banks, it is on the people who try to create jobs. That is why we have had this deep, long-lasting recession from which it is hard to recover. This is a typical experience of a finance-induced deep recession, unfortunately.

I think when we look at the implementation of Dodd-Frank, we should be careful with regard to unintended consequences. I think the regulators came under appropriate pressure from both Republicans and Democrats because of the TruPS CDO issue. They responded in a way that I believe to be appropriate. I hope that you will continue to watch on these same details.

However, I also recall that 2 years ago I appeared in a hearing before this committee along with a number of other witnesses, many of whom predicted dire consequences if the Volcker Rule were to come anywhere near to becoming a reality.

Financial markets are forward-looking. As you know, we have the rule. Some details no doubt remain to be fully clarified. But we have the rule, and we have financial market reaction. Have we seen the drying up of sovereign bond liquidity? Have we seen big increases in spreads in the way that were predicted? I don't believe so.

If we do see consequences, unintended consequences, of course they should be addressed, and I think it is admirable that you are holding this hearing and you are holding these other hearings. That is exactly what we need, to look at the consequences, intended and unintended.

In that context, I hope you also think again about business development corporations, which reportedly are being considered as a vehicle through which some of our largest bank holding companies—at least one of them—could find their way again into highly speculative proprietary betting type of business. So that is not how they are currently used, but that is how they could be used. Hopefully, we will have some discussion also about CLOs in that context as well.

To conclude, the Volcker Rule has a good chance of reducing systemic risk. It requires appropriate oversight from Congress. I am encouraged that you are providing that oversight. It requires the regulators to avoid and prevent the development of new loopholes.

Thank you very much.

[The prepared statement of Professor Johnson can be found on page 104 of the appendix.]

Chairman HENSARLING. Mr. Ganz, you are now recognized for 5 minutes.

STATEMENT OF ELLIOT GANZ, EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL, THE LOAN SYNDICATIONS AND TRADING ASSOCIATION (LSTA)

Mr. GANZ. Thank you. Good morning, Chairman Hensarling, Ranking Member Waters, and members of the committee. My name is Elliot Ganz, and I am the general counsel of the The Loan Syndications and Trading Association, or LSTA. The LSTA is an association which represents the interests of the many participants in the $3 trillion commercial loan market. We thank you for the opportunity to testify at this timely hearing.

My testimony will focus on how the Volcker Rule's definition of ownership interest could negatively impact credit availability for American companies by profoundly disrupting the market for open-market collateralized loan obligations, or CLOs. This disruption could lead to a significant reduction in the amount of credit available to some of the most dynamic job-creating companies in America and would result in material and arbitrary losses to American banks which hold almost $70 billion of safe, well-performing CLO debt securities.

The best place to start is by describing what a CLO actually is. A CLO is a securitization fund managed by an independent SEC-registered investment adviser which issues securities and then uses that money to provide loan financing to American companies. CLOs finance approximately $300 billion of these loans, representing almost half of all loans made by nonbanks in the United States.

These loans are made to some of the most dynamic companies in America, across all States and all industries, including broadband, satellite, cellular, health and hospitals, energy, airlines, automotive and retail. Who are these companies? They include such iconic American companies as Sears, Aramark, SuperValue Stores, Rite Aid, Good Year Tire, and Delta Airlines, who together employ hundreds of thousands of Americans. Hundreds of smaller companies also rely on CLO financing, including Regal Cinemas, Armstrong World Industries, ABC Supply, TempurPedic, and Quikrete ®. Just these five companies alone employ almost 50,000 people.

Many of these smaller companies have no access to capital markets other than through the loan market. In all, we estimate that companies which access the CLO market for financing employ more than 5 million people.

CLOs have performed remarkably well over the years, including during and after the great financial crisis. Since 1996, cumulative realized losses to CLO debt securities has been less than 1 percent.

Attracted by the safety and soundness of CLOs, their historical performance, and their reasonable risk-adjusted return, a wide range of U.S. banks currently invest almost $70 billion in the highest-rated debt securities. While a significant amount of CLO debt securities are held by large banks, they are also held by at least 30 other banks, including 21 with assets less than $25 billion, many of which are community banks.

To be clear, banks are not buying CLO equity. These are the highest-rated debt securities of CLOs. They have none of the characteristics of equity and are simply not ownership interests. Yet, the Volcker Rule artificially and arbitrarily converts CLO debt securities into the equivalent of equity through an expansive definition of ownership interests, thereby making them prohibited to banks.

Because the ability to restructure $70 billion of these securities is extremely challenging and the prospect highly doubtful, banks will be forced to divest, putting downward pressure on prices for CLO debt, thereby triggering further selling pressures, leading to a cascade of falling prices, despite the fact that these remain very high-performing, safe assets.

The agencies yesterday provided limited relief to holders of CDOs and trusts. This was a $600 million accounting loss recognition problem. In contrast, if the price of CLO debt securities were to drop by only 10 percent, banks holding them would face potential capital losses of up to $7 billion, losses that would be attributable solely to the imposition of the final Volcker Rule. This furthers no regulatory objectives.

The good news is that there is an easy regulatory fix to this problem. It requires no exemption or carve-out, simply guidance from the agencies that the term "ownership" as defined in the final rule does not cover CLO debt securities that contain only a contingent right to remove or replace a manager for cause, but contain none of the other indicia of ownership listed in the definition. We believe that adoption by the agencies of this simple proposal would allay the concerns of the CLO market and we urge the involved agencies to issue this guidance in the coming days so that CLOs can continue to provide financing to American companies.

Thank you, and I look forward to your questions.

[The prepared statement of Mr. Ganz can be found on page 97 of the appendix.]

Chairman HENSARLING. Mr. Robertson, you are now recognized for 5 minutes.

STATEMENT OF DAVID C. ROBERTSON, PARTNER, TREASURY STRATEGIES, INC., ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. ROBERTSON. Thank you, Chairman Hensarling, Ranking Member Waters, and members of the committee. I am appearing on behalf of the U.S. Chamber of Commerce. I participated in the CFTC roundtable on the Volcker Rule, and my colleague, Anthony Carfang, has testified before both House and Senate subcommittees on the subject as well. I am here to represent the perspectives and viewpoints of corporate treasurers.

In these forums, we have raised concerns regarding unintended consequences the Volcker Rule could cause. These include impaired market liquidity and reduced access to credit and capital, higher costs and less certainty for borrowers, potential competitive disadvantages for U.S. businesses and financial institutions, increased compliance costs, higher bank fees, a shifting of risk out of banks into other less well-regulated sectors of economy, and capital flows into offshore markets. The true effects of this mammoth regulation will not be known until the conformance period ends; however, some problems which impact both businesses and individuals are coming into focus.

It is important to recognize that U.S. businesses benefit from the most efficient capital markets in the world. Companies doing business in the United States operate with roughly $2 trillion of cash reserves, and that represents only 11 percent of U.S. GDP. In contrast, corporate cash in the eurozone is 20 percent of GDP, and in the U.K., the ratio is even higher at 32 percent.

Reduced access to capital or certainty of access will require companies to hold more cash on their balance sheets, slowing economic growth. And how will companies generate more cash? Through layoffs, reducing dividend payouts that retirees depend upon, and by forestalling capital expenditures which fuel growth.

Mr. Ganz did an excellent job of noting the jeopardy that the Volcker Rule places around collateralized loan obligations, but this may be only the first wave of capital formation problems that could arise.

It is also noted that harmonization of the rule is needed. The Volcker Rule was written by five separate agencies, each with different areas of responsibility and different tools, histories, and processes for regulation and enforcement. Capital investment by business requires a stable and predictable regulatory environment. For the Volcker Rule to work and support economic growth, it is critical that its interpretation and enforcement be harmonized amongst all of the regulators to provide clear rules of the road.

The real impacts of the Volcker Rule will not be known until the end of the conformance period winds down; however, we need to be particularly vigilant to its impact because currently we are under a very unusual macroeconomic scenario characterized by quantitative easing, which has pumped excess liquidity into the economy. We fear that this quantitative easing may actually mask the effects of the Volcker Rule for a period of time, but the start of the wind-down of QE is under way, and the potential has already boosted long-term rates.

The Volcker Rule will not be implemented in a vacuum. We face a time of unprecedented regulatory change. Corporate treasurers have to contend with looming money market regulations that could imperil 40 percent of the commercial paper market, Basel III lending requirements, Basel III disincentives for commercial lines of credit, and the implementation of derivatives regulations that could reduce the ability of businesses to mitigate risk and ensure affordable access to raw materials. All of these dynamics are converging in one place, on the desktop of the corporate treasurer, and their combined impact upon a business' ability to raise capital and appropriately take on and manage risk has not been fully vetted or thought through.

Lastly, I would like to draw attention to some rulemaking process and procedural flaws that raise concerns about the level of rigor that was conducted in crafting the regulations. The process to create the regulations did not permit sufficient dialogue. There was a comment period, but the nature of the regulation was so far changed that a reproposal would have been well in order. It also did not entail the required cost-benefit analysis or an assessment by the SEC on its impact on capital formation.

Accordingly, we would respectfully request that Congress review the procedures for rule writing, especially with joint agency rulemakings, to ensure fair procedures for input and comment and hold agencies accountable in the consideration of the impacts and the costs on the economy and businesses.

I appreciate the opportunity to appear before you today on behalf of the U.S. Chamber of Commerce. The Chamber supports the passage of H.R. 3819 and respectfully requests that the bill be amended to include an exemption for CLOs.

Thank you. I look forward to answering your questions.

[The prepared statement of Mr. Robertson can be found on page 111 of the appendix.]

Chairman HENSARLING. The Chair now recognizes himself for 5 minutes for questions.

Mr. Robertson, I think I just heard you in your testimony say that because of an aspect of the Volcker Rule, companies may have to build up to $1 trillion of additional cash reserves. Did I understand that correctly?

Mr. ROBERTSON. That is correct.

Chairman HENSARLING. I have to tell you, even by congressional standards, that is a fairly staggering number.

I think I also heard you say that from your experience, companies may have to downsize and lay off workers. You were here for my opening statement. I am thinking about two constituents I have, Claudia and Joseph, who are either unemployed or underemployed. So elaborate how you come to the conclusion that these companies may have to downsize and lay off workers because of the Volcker Rule.

Mr. ROBERTSON. Thank you.

One of the things that is a characteristic of our financial market is very robust capital markets, very strong access to commercial credit. So as a result, companies are able to invest, they are able to support their working capital needs through just-in-time financing. This allows them to run their balance sheets very efficiently and direct their cash toward working capital and investment.

The minute that companies begin to doubt the ability of the market to provide financing for them or to manage financial risk, they are going to need to insure themselves against that, and that is going to require them to hold more cash, because they won't know if they can get credit; and secondarily it is going to require them to hold more cash to hedge financial risks if they don't have access to derivatives and other hedging tools that are used for their activities. Basically, the comparison is between the United States with its robust markets, and Europe and the U.K., which have less robust markets.

Chairman HENSARLING. Mr. Ganz, you spent a fair amount of time in your testimony speaking of the CLO market. You also have a fairly staggering number—I notice, on page 2 of your testimony:

"In all we estimate that companies that access the CLO market for financing employ more than 5 million people." How do you derive that statistic?

Mr. GANZ. We did a survey of all of the loans that were held in CLOs, and then we tracked that against—we used a service to track that against how many employees each of those companies employed.

Chairman HENSARLING. You also say in your testimony, "Often these growing job-creating companies have no other access to the capital markets other than through the loan market," specifically speaking of the CLO market. How did you come by that conclusion?

Mr. GANZ. The companies that borrow through CLOs are called non-investment-grade companies. That means they have no ratings, so they can't access the investment grade markets. They can't access the regular bond market. Some of them can't even access the high yield market, particularly the smaller ones. So the only place they can get money is from the leveraged loan market. That is an institutional market largely, and CLOs provide 50 percent of the financing in that market. So it is a very big deal. And, again, I think it is very important to note most companies in America are non-investment grade.

Chairman HENSARLING. Like many other Members of Congress, again, I have constituents who are unemployed, I have constituents who are underemployed, and my guess is if I did a survey, most have never heard of the Volcker Rule, most have never heard of the collateralized loan obligation market. What should I tell these constituents about why they should care about the Volcker Rule?

Mr. GANZ. In this context, the expansion of one paragraph in one small section of the Volcker Rule artificially converts debt securities into equities and has a profound impact on the banks that hold these. Those banks are going to have to divest their securities. So besides the impact that it has on the CLO market itself, the banks that hold those securities are going to take an immediate capital hit. If they take an immediate capital hit, they are going to have less money to lend into those communities.

Three banks filed letters to the agencies, three smaller banks with assets in the $20- to $35 billion range, and they addressed that specifically. They have somewhere between $300 million in CLO notes up to about $1 billion, and if they have to take a $30 million hit or more, that is going to be less money available to lend into their communities.

Chairman HENSARLING. Thank you. My time has expired.

The Chair now recognizes the ranking member for 5 minutes.

Ms. WATERS. Thank you very much.

To Mr. Funk, and I think Mr. Johnson, and maybe others who recognize that both sides of the aisle cooperated and worked to make sure that the regulators quickly addressed the TruPS CDO issue, and just as we were able to do that, I think that we are able to work with regulators on some of the other issues that are being identified, such as the CLO issue. And I think that we should be focused more on what we can do to implement Volcker, because it is the law, but at the same time deal with any unintended consequences. And since we have already demonstrated that we are willing to do that, and the regulators are showing that they are willing to respond, let us focus on what we can do to make sure that we deal with some of the other issues with which you are concerned.

For example, CLO. Let us take the CLO issue, Mr. Robertson. You have identified this as a real concern. Have you thought about ways in which the regulators can address these concerns, and are you willing to work with us to address these concerns?

Mr. ROBERTSON. Yes, absolutely. And I think actually Mr. Ganz outlined clarifying that CLOs were not meant to be captured under the rule that was trying to catch hedge funds. So clarifying that these are debt securities, not equity securities, they are not deemed to have an ownership interest in equity.

Ms. WATERS. Are you willing to work with us in the way we just demonstrated we can work on unintended consequences?

Mr. ROBERTSON. Oh, absolutely.

Ms. WATERS. Mr. Johnson, a number of comments have been made about compliance, and, of course, Mr. Funk, we are concerned about any costs that are caused by compliance, and we want to make sure that we do everything that we possibly can to assist you with compliance without costing a lot of money to the bank. How can we do this, Mr. Johnson? Do you have any thoughts on that?

Mr. JOHNSON. Congresswoman, I understand that the regulators are addressing this. It is a live issue. I am not sure it is completely resolved. But incorporating a relatively minor compliance requirement within the existing reporting and supervision for community banks, I think that is—I am not saying it is trivial, but that is not adding a big additional burden. I think that makes sense.

This rule is not targeted at the community banks. There are some spillovers that you are identifying in this discussion. But I think you can incorporate it within the existing supervisory framework.

If I could just add a point on the CLOs, Mr. Ganz has a very straightforward proposal, which is an FAQ issued by the regulators; not even a new rule or clarification, just a frequently asked question and the answer to such a question. And I think he puts his finger in his written testimony, which I have only looked at quickly, on the key issue, which is the banks can make loans, that is what banks do, but they can't take an equity interest in certain investments to the degree they used to. So that is what—in his written testimony Mr. Ganz is differentiating that quite carefully. And I think, again, these are sensible ideas that you can absolutely work on with the regulators.

Ms. WATERS. Mr. Funk, in terms of compliance, do you believe that we can work with you to reduce costs to the community banks for compliance efforts?

Mr. FUNK. Absolutely.

And I will say, just to give you an example with regard to the Volcker Rule, I represent a community bank and I didn't pay much attention to the Volcker Rule until about December 10th. It was then when I found out that we were going to have to take a million-dollar charge. And that is why we are so appreciative for both sides of the aisle taking a stand on this, because we had to have this resolved. We have left our books open. Normally, we close our books on the 3rd or 4th day of the month. We had to leave them open, but were finally able to close them today because of the announcement from the regulators. So, thank you so much for your help on that.

Ms. WATERS. You are so welcome.

Mr. Bentsen, you have worked in this House, and you have seen efforts for cooperation from both sides of the aisle, and you have seen times when we have not cooperated. And so, given what you are looking at now, based on the work that both sides of the aisle did recently, don't you think that we can resolve some of these concerns, these unintended consequences, without going at destroying the Volcker Rule?

Mr. BENTSEN. Congresswoman, absolutely. I think what happened with the trust preferreds was very positive, but I think it is indicative of problems in the underlying rule itself. It is very complex. The CLO issue has arisen. There are going to be others that are coming going to come up. The coordination issue is huge, and Congress absolutely has a role to play.

The law belongs to Congress. It is the regulator's job to implement it, but Congress has a role to oversee the law and make sure it is done appropriately.

Chairman HENSARLING. The time of the gentlelady—

Ms. WATERS. I yield back.

Chairman HENSARLING. —has expired.

The Chair now recognizes the gentleman from New Jersey, the Chair of our Capital Markets Subcommittee, Mr. Garrett, for 5 minutes.

Mr. GARRETT. And, again, I thank the chairman.

I will start down at this end of the panel.

Congressman Bentsen, good morning. As you may know, SEC Commissioner Mike Piwowar has stated that, "rulemaking agencies failed both at the proposing and adopting stages to prepare an economic or other regulatory analysis of the Volcker Rule. As a result, we do not know what the rule's economic impact will be or whether other alternatives might have accomplished the goals of the rulemaking at a lower cost with less disruption of the capital markets."

So my first question is, do you agree with his statement that they failed to abide by the law, by the Administrative Procedures Act (APA), and to do a robust economic analysis and find out if there are other alternatives out there?

Mr. BENTSEN. Congressman, I won't opine with respect to the APA, but I will say that—first of all, we called for a robust economic analysis in our comment letter. We thought that was entirely appropriate. As you know—

Mr. GARRETT. You did?

Mr. BENTSEN. —the APA applies—

Mr. GARRETT. You did call for that?

Mr. BENTSEN. Yes.

As you know, the APA applies differently to different agencies. And, in particular, the prudential regulators do not have the same burden that the independent agencies—and certainly they don't have the same burden that other Executive Branch agencies have. So, that is actually a role that Congress should probably take a look at going forward.

Mr. GARRETT. So, regardless of what the APA may say, it is your opinion, I guess is what you are saying, that an economic analysis, and a robust one, should have been done in this situation.

Mr. BENTSEN. We believe so, yes.

Mr. GARRETT. Okay. Great. Thanks.

Running down to Professor Johnson, I was reading through your testimony last night and watching the Senate hearing of your testimony last week. In both cases, you repeatedly stated, as you did this morning, that the impacts of the rules are overstated. Specifically, you state, "Financial markets are typically forward-looking—you just said that this morning—so the expected future effects of any such rule are likely to be felt in advance of full implementation, yet none of these negative consequences has actually transpired." And you just said that this morning.

But if I go down to the end of the table to Mr. Robertson, you said in your testimony, in written testimony and what you said just now, "Because of the 18-month conformance period, it is not possible to understand the full impact of the Volcker Rule, particularly on Main Street businesses, until the rule is completely implemented and operational at the financial institutions."

And you also said—and I thought it was an astute point—both in your written testimony and right now, that the QE, quantitative easing, and the extraordinary impact that has had on the bond market is also significant.

So I will bring it back to Professor Johnson. I am sure you are familiar, being an academic, with the portfolio balance channel theory—and this is something that Ben Bernanke has talked about in the past—which basically says, as you do QE, what does that do? It affects the price—it affects the price going up; the yields are going down. And what does that do to the marketplace? People have to go into the marketplace to try to find similarly situated risk that they could have had but for the fact of QE. And that essentially means that bond investors would have to go further out on the credit-risk curve to buy corporate bonds.

That is what the effect has been in the corporate bond market because of QE, right? And I see Mr. Robertson nodding to that.

So aren't you missing the mark when you say that we can look to current activity in the marketplace if we fail to consider what the effect is of QE today, and if we fail to consider the fact that tapering will occur in the future and the combined effect of those on the bond market?

Mr. JOHNSON. No, Congressman, I don't—

Mr. GARRETT. Why not?

Mr. JOHNSON. —believe I am missing the point. If you look at the testimony that was provided at the previous hearing before this committee—for example—

Mr. GARRETT. I did.

Mr. JOHNSON. —I testified before the CFTC hearing, and one of Mr. Robertson's colleagues was there. There was plenty of talk about immediate consequences, for example, on sovereign yields in Europe and on risk spreads. And it is not clear that QE would affect all the risk spreads in the way that you are indicating.

Now, it is true we have a particular set of monetary policies right now in this country. It is also true the Federal Reserve has exerted a lot of control over dimensions of the credit conditions, and they may well continue to want to do that going forward. I agree that those things are interacting.

But my point is, in terms of the predicted consequences, in terms of the concrete, actual things that have changed, not Mr. Robertson's conjectures about what might change in the future, what have we actually seen change in a negative way? And that is my point, Congressman.

Mr. GARRETT. That is my point, that you are looking at what is happening today, but you cannot push that to the future because in the future we will not have the QE. The QE, under this theory and under—I think most people agree that it has had an effect on price and yield and has pushed the market out into this area. So you can't say that what is going to occur today is going to be in the future.

My time is almost up, and, gosh, I was going to give Mr. Robertson the last word, but I see the chairman is quick with the gavel, as always.

Chairman HENSARLING. The Chair now recognizes the gentlelady from New York, Ms. Velazquez, for 5 minutes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Robertson, you mentioned that U.S. companies will need to raise an additional $1 trillion to comply with the Volcker Rule, yet hedging for ordinary business operations is exempt. I just would like to know how you calculated this figure?

Mr. ROBERTSON. First of all, I wouldn't claim that they would have to raise $1 trillion. What I was trying to distinguish was the level of cash that U.S. businesses hold on their balance sheets to support the economy and contrast that with the U.K. and the European Union, which have less robust capital markets.

What we have done is we have compared the cash holdings published by the Federal Reserve to GDP to those published by the Bank of England, and the European Central Bank, and noted the lower level of cash proportional to the economy that U.S. corporations hold.

And so our concern is, we know from our experience in working with corporate treasurers that one of the reasons why they don't have to hold that much cash is the efficiency of the system, the reliability of access to capital. We are not stating it will be $1 trillion, but our concern is that anything which reduces that efficiency could force U.S. businesses to hold more cash.

Ms. VELAZQUEZ. Professor Johnson, would you like to comment?

Mr. JOHNSON. It is a fascinating calculation Mr. Robertson is presenting, but I don't see that it has any basis in fact whatsoever, in the sense of what is the impact on the efficiency of the financial market, of the Volcker Rule. I am sorry that Mr. Garrett has left the room, but this is exactly the point.

If there were a disruption to the financial markets, if it were becoming harder to access credit, if corporate treasurers were fearing their access to short-term financing, those would be legitimate concerns, but we would see them now. The markets would already be disrupted.

And that is what previous fellow witnesses have testified to; they said the effects are coming now, right away, immediately, because the financial markets are forward-looking. Where do we see this disruption concretely for corporate treasurers?

Ms. VELAZQUEZ. Professor Johnson, is there any Volcker Rule comparison in Europe at this point?

Mr. JOHNSON. There is plenty of discussion in Europe about finding ways to separate commercial banking, the utility-type commercial banking, from relatively risk-taking investment banking.

The very latest moves—but I would caution that the Europeans go back and forth on this—is to move towards more of a Volcker-type approach, limits on proprietary trading, away from the so-called ring-fencing or the separation of activities.

But the European policy is not completely settled. And I would certainly not wait for the Europeans to sort out their banking system, which is an enormous mess, supported by massive government subsidies. You really do not want to go to what the Europeans have.

Ms. VELAZQUEZ. So, Professor, there is no rule in Europe at this point that is costing $1 trillion to Europeans?

Mr. JOHNSON. There isn't a—they are not holding more cash because of some impact of an equivalent to the Volcker Rule, that is correct.

Ms. VELAZQUEZ. Professor, Dodd-Frank provided the financial industry with a number of exemptions to the Volcker Rule, understanding that most trading was for legitimate business purposes such as helping small businesses hedge risk. And yet, some industry participants continue to argue that the Volcker Rule will negatively impact access to capital for small businesses.

Have you seen any report, any evidence, any statistics, any report to that matter?

Mr. JOHNSON. No, Congresswoman, I haven't. I have not seen credible independent analysis to that point.

I think it is a very important point, but remember, the Volcker Rule is targeted at the largest six or eight bank holding companies. We have big, liquid, deep markets. Mr. Robertson is absolutely correct on that. Those markets have not been disrupted by what we have seen so far. And given the trajectory which is implied by the latest rule clarification, including yesterday's, I don't think we are going to see that disruption.

Ms. VELAZQUEZ. Thank you.

Mr. Funk, there has been a lot of discussion recently about the treatment of TruPS CDOs under the Volcker Rule. However, the fact remains that these are risky assets which could undermine the safety and security of the small pool of banks that hold them.

If not 2 years, as drafted, what is a reasonable amount of time to divest these assets, given the demonstrated poor performance of these TruPS CDOs?

Mr. FUNK. These were debt securities when we bought them, not equity securities. And when we bought them, they were investment-grade, they were not what we would consider in our bank to be a risky asset.

We have written them down. We bought $9.7 million. We wrote them down to about $1.7 million. We, in 2008, charged off $8 million, so our holding value is $1.7 million.

I think the key thing, Congresswoman, is on this particular point, if we hold these for another 10 or 12 years, we are almost certain we will recover more than our book value. We have plenty of capital in our bank, we are able to hold them, but the rule as it was proposed would have required us to take a hit right now—

Ms. VELAZQUEZ. So what is a reasonable time?

Chairman HENSARLING. The time—

Ms. VELAZQUEZ. That is my question.

Chairman HENSARLING. —of the gentlelady has expired.

The Chair now recognizes the gentlelady from West Virginia, the Chair of our Financial Institutions Subcommittee, Mrs. Capito, for 5 minutes.

Mrs. CAPITO. Thank you, Mr. Chairman.

I would like to follow up, Mr. Funk, where you left off. You have already written down—let's start, when you first purchased these securities, they were not considered risky investments and were really—the reason they took such a dive was as a part of the recession, the financial crisis. Is that correct?

Mr. FUNK. That is correct.

And what I will tell you is in our bank in Iowa City, when we bought these in 2005 or 2006, there was a lot of discussion. We decided to limit it to $10 million. We wound up with $9.7 million. As I recall, they were all rated either A or A1 by Moody's, and they were investment-grade. They survived bank examinations, and they were not considered a risky asset. But, like many things, they were a casualty of the recession.

Mrs. CAPITO. Right. And you are still receiving revenue from this. This was part of the reason that you purchased these, correct?

Mr. FUNK. They are not—we will receive revenue. We are not right now. But the way the pools work is that as the banks continue to pay, eventually you get revenue. Our particular class that we hold is not getting cash right now.

Mrs. CAPITO. It is not a revenue—

Mr. FUNK. But we are very confident that in the next 10, 12, 15 years, we will recover all of our book value and then some, perhaps.

Mrs. CAPITO. Okay.

I would like to ask a question on two things, quickly. I have been working with Mr. Meeks on some legislation to say, if we are going to move new regulations forward, understanding that regulations have to move with the time and the instruments and what is moving on, I get that, but what are we going to do about the old, existing, antiquated, no-longer-useful-but-still-must-be-complied-with regulations?

And we are working on a scenario where we would say to the regulators, before you move forward with something that is complicated, like the Volcker Rule, you have to look at where the existing regulations are right now, and are they useful, are they compatible, or would it be better to move in the new while you are taking out the old?

Does anybody have a sense that kind of exercise took place during the enactment of this rule?

I will start with you, Mr. Funk, then anybody else.

Mr. FUNK. That I don't know. What I do know, and I think it has been said elsewhere, and is something that really concerns me, is that our particular bank is subject to the regulation of three entities: the SEC; the Federal Reserve for our holding company; and the FDIC for our bank. And the way the Volcker Rule is written, they can all enforce the Volcker Rule differently, and I think that creates a lot of confusion. So we do need more uniformity. But I certainly agree with the intent of your question.

Mrs. CAPITO. Mr. Bentsen?

Mr. BENTSEN. Congresswoman, first of all, I think that is an outstanding idea, and I don't think it is limited to the Volcker Rule or limited to—

Mrs. CAPITO. Right.

Mr. BENTSEN. —the potential regulators. I would argue you could add FINRA to that and what is going on with the consolidated audit trail and the Order Audit Trail System (OATS) that exists today.

So we don't want to build redundant regulation or redundant systems. And we have seen—and I think this is an example in Volcker, dealing with the trust preferred issue, where you basically had legal definitions conflicting with the accounting rules, where apparently no one was talking to one another to figure out what was going on. And we are going to find more of that. This is too big of a rule that we won't.

Mrs. CAPITO. Right.

Mr. BENTSEN. And I think we will see that in the capital standards, as well, where we are laying Basel III on top of Basel 2.5 on top of Basel II. And, again, we know that there will be conflicts in there.

Mrs. CAPITO. Yes, Professor?

Mr. JOHNSON. Congresswoman, I think you are making a very good point. But part of the point of the comment procedures and process was exactly to let the industry speak to any kind of issue, including problematic legacy issues.

Now, the TruPS CDOs didn't come up, and that was unfortunate—

Mrs. CAPITO. It wasn't in the rule.

Mr. JOHNSON. No, I understand. And as I said, that was unfortunate, and has been addressed in, I would suggest, record time by the regulators, because you all agreed this was a problem.

I think that the right way to do this is exactly to have a long period of time—we have had 3½ years of comments and back-and-forth with the industry. If you can find additional legacy, leftover problematic issues, absolutely, you should go after them with Mr. Meeks—

Mrs. CAPITO. Right.

Mr. JOHNSON. —but there has been a very detailed process already.

Mrs. CAPITO. Thank you.

And I guess my question concerns the next step. Does anybody on the panel have a sense that it actually occurred?

Mr. Robertson?

Mr. ROBERTSON. I don't have a sense it occurred. I know there was a mandate for the regulators to coordinate. But just given the scope of the effort and the amount of time that took place, as you point out, there was no re-proposal. And I think there needs to be much closer working around these regulations with the various constituencies to surface these issues. It is great to address unintended consequences after the fact, but, at that point, there is a lot of disruption already created.

Mrs. CAPITO. Right.

The other issue—I will just make a comment, because I don't have time for another question, really—is what you are all talking about, the complexity of what we are dealing with here. And I think that is not just a burden in terms of trying to figure it out, but it has a financial burden that is attached to it, too, that does translate to Main Street.

And so I say good luck to all of us for figuring out the complexity of this rule and seeing the ramifications as we move through this.

Thank you so much.

Chairman HENSARLING. The Chair now recognizes the gentlelady from New York, the ranking member of our Capital Markets Subcommittee, Mrs. Maloney, for 5 minutes.

Mrs. MALONEY. I want to thank the chairman for recognizing me, and thank the ranking member, and thank all of you for your important testimony and for being here today.

We all know that the problem of the crisis, the financial crisis, was not caused by community banks or regional banks or credit unions. And many of us on this panel are working very hard to shield them from unnecessary regulation.

But we know from many books and from the GAO report that I have with me that proprietary trading was a cause, and, in fact, in this report they call it a leading cause, of the financial crisis. We know it was the CDOs; we know that it was certain bad lending practices. And this Volcker Rule takes care of this problem. So we need to put it behind us and go forward.

Now, if there is something that needs to be adjusted, such as the trust-preferred CDOs—which, according to testimony, the rule that came out from the regulators, the adjustment, takes care of the challenge. Is that correct?

Mr. FUNK. As far as I know, it takes care of the vast, vast, vast majority of banks in America.

Mrs. MALONEY. Then, if there are unforeseen consequences, let's take care of them, but let's go forward. The Volcker Rule is here. It is going to stay. It is now part of the fabric of our country.

But one area that was raised in your comment letter, Mr. Bentsen, you said that the proposed rule—and this may be an adjustment that needs to take place. Your organization raised serious concerns with the definition of a banking entity, which you argued was far too broad. Does the final rule address your organization's concerns on this issue?

And if it doesn't, how would you propose fixing this problem? Is it possible that the final rule will sweep in purely nonfinancial operating companies because of this broad definition?

That was in your comment letter.

Mr. BENTSEN. Sure.

As we have been going through it, it does appear that the regulators did narrow the definition of "banking entity" and they narrowed the definition of "covered funds." However, I will give you one example that is causing a great deal of concern.

In "covered funds," registered investment companies, what we would think of as mutual funds, retail mutual funds were explicitly exempted where they had not been in the proposed rule. However, they are not exempted under the definition of "banking entity." So, in effect, you already have a conflict now where, on the one hand, mutual funds are not treated as covered funds under the funds section, but they are captured by way of being defined as a banking entity if they are affiliated with a bank, which many mutual funds are.

So, again—

Mrs. MALONEY. It just seems like it could be an issue which could be handled by the regulators. And if a nonfinancial subsidiary doesn't do any proprietary trading or investing, why should anyone have to worry about it?

Mr. BENTSEN. I think what it is indicative of—a couple of points of what it is indicative of, is the broadness and complexity of this rule and the fact that today it is trust preferreds, tomorrow it is CLOs, the next day it is 1940 Act registered funds, that we are going to find these things going through. And it is going to take a lot of work, hence the reason for Congress to continue to play a very active role in this process.

The second point—and I want to respond to Professor Johnson—is that regardless of what everyone thinks the intent was or wasn't, this rule, by practice and by the way it is written, has an extremely broad impact. It doesn't just affect the top five largest institutions; it affects any banking institution that has—anybody who is affiliated with a banking institution. So it has a very broad impact. And the rule is written as such to indicate that it has that broad reach.

Mrs. MALONEY. If an affiliate isn't doing proprietary trading, then it wouldn't affect them.

Mr. BENTSEN. But, Congresswoman, with all due respect—

Mrs. MALONEY. I would say that this panel—certainly many of my colleagues and I, if there is any adjustment that needs to take place, we will be a strong voice in helping that adjustment and certainly shielding community banks and regional banks and credit unions that did not cause the crisis.

I have one other question. Mr. Volcker, in his written statements—and I would like to put his statement in the record. I thought it was excellent.

Chairman HENSARLING. Without objection, it is so ordered.

Mrs. MALONEY. He said that the rule will change—and I am quoting from his statement—the tone at the top, because it requires CEOs to certify that they have adequate compliance procedures in place.

And I would like to ask anyone to comment. Do you think that—okay, Mr. Ganz, would you comment on if you think that will be—and Mr. Robertson?

Mr. Ganz and Mr. Robertson and Mr. Johnson, you all had your hands up.

Chairman HENSARLING. Very quickly, because the time of the gentlelady has expired.

Mr. ROBERTSON. I think that is a basic fiduciary duty of any bank CEO, to fully comply with all the regulations and also to appropriately manage risk.

Chairman HENSARLING. The time of the gentlelady has—

Mr. BACHUS. Mr. Bentsen was also trying to respond to her question about whether community banks will be affected.

Chairman HENSARLING. I understand that, but the time of the gentlelady has expired.

And the chairman emeritus happens to be next in the queue, so the Chair now recognizes the gentleman from Alabama, our chairman emeritus, for 5 minutes.

Mr. BACHUS. I will answer like Mr. Bentsen would say. The community banks are affected.

Mr. BENTSEN. Congressman, I would just say, and in response to Congresswoman Maloney, the point is that all of these banks are captured, and it is not a question of whether they are doing something that is prohibited. It is the fact that they are subject to the compliance requirement on what they are allowed to do as Congress intended in the statute, but they have to go through all of these hoops of this new compliance regime to do what Congress said they could do under the statute.

Mr. BACHUS. Thank you.

And could I get that put back on my time? That was in response to her question. But it needed to be said.

Chairman HENSARLING. I am afraid not.

Mr. BACHUS. Thank you.

In Mrs. Maloney's opening statement, she again talked about how proprietary trading was central to the financial crisis. Professor Johnson, I think you sort of agreed with that. She quoted a GAO report that she says claims that it was central, but if you read it, it says it wasn't central, it says it wasn't a cause of the financial crisis. So, I am going to introduce that.

This whole Volcker Rule is a response to the financial crisis, because people keep saying that it was caused by proprietary trading.

Professor Johnson, you talked about mortgage-backed securities, and you said that was proprietary trading. But, it is not. The regulators encouraged the banks to hold mortgage-backed securities long-term. That wasn't proprietary trading.

None of the five banks—really, the banks didn't fail because of proprietary trading. Even Paul Volcker said—and I will quote him, "Proprietary trading in commercial banks was not central to the crisis." Secretary Geithner said, "If you look at the financial crisis, it did not come from proprietary trading activities." Even Raj Date of the Consumer Financial Protection Bureau—he was the deputy—was for Dodd-Frank. He said, similar to what Mr. Bentsen said, "The Volcker Rule is a solution to a non-problem."

Professor Johnson, you are the Democratic witness. I think what you are responding to is too-big-to-fail. I think that is why you want the Volcker Rule. Am I correct?

Mr. JOHNSON. Too-big-to-fail is a very important and persistent problem, Congressman, but irrespective of the approach that you prefer to tackle it, I would still recommend some version of the Volcker Rule.

Mr. BACHUS. Why? If a bank—if they trade and lose money, should the government prohibit that if there is no taxpayer interest?

Mr. JOHNSON. If a small trading house takes speculative proprietary bets and loses and goes out of business, I think that should hopefully be of no concern to any of us. But it does interact with size, scale, complexity, and systemic consequences, some of which we can anticipate and some of which catch us unawares every time. So it is that systemic impact that creates the implicit government support, including the support from this and previous Congresses.

Mr. BACHUS. I think that is what you are afraid of. I think you are afraid that they are still too-big-to-fail, even though the Administration—you and I agree that Dodd-Frank didn't end too-big-to-fail. You can still have systemic risk.

But I think what you really want to do, and tell me if I am wrong, is you want to break up these big megabanks. Am I correct?

Mr. JOHNSON. Congressman, if you were willing to make them small enough and simple enough so they could all fail, and go through bankruptcy without causing any systemic consequences, then, yes, I would say, let them get on and run their businesses—

Mr. BACHUS. And I believe that is your motivation, is you want to break these banks up.

And let me say this. I have 20 seconds. The problem I see with that is we are in a global economy and they are global megabanks, aren't they?

Mr. JOHNSON. There are some highly subsidized socialized banks coming from other countries. That doesn't mean we should emulate—

Mr. BACHUS. But, they are global.

Mr. JOHNSON. There are some global banks—

Mr. BACHUS. And they can move their proprietary trading somewhere else, and we can't prevent that.

Mr. JOHNSON. If they move it outside of where it causes problems for our economy, perhaps we shouldn't be concerned. But if it is a bank like JPMorgan Chase, it is going to lose—

Mr. BACHUS. But no other country has adopted the Volcker Rule.

Mr. JOHNSON. If they are going to lose big in London, Congressman, and that is going to affect the bank holding company in the United States, then we have to worry about—

Chairman HENSARLING. The time—

Mr. BACHUS. You are a British American. Britain has not passed a Volcker Rule, nor any other country, and they are not going to.

Chairman HENSARLING. —of the gentleman has expired.

The Chair now recognizes the gentleman from Massachusetts, Mr. Capuano, for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman.

I want to thank the panel for their testimony.

I have to be honest. This stuff, for me, I kind of always feel like I am up to my nose in it, because it is tough stuff. It might be easy for all you guys; you are all a lot smarter than I am. I have spent most of the week trying to figure out how many points I can get out of Ed Perlmutter for the Patriots-Broncos game. That is about as complex as I can get.

And it is kind of interesting, when I hear the complaints about a complex rule, it presumes that CBOs and CLOs and CDO TruPS and CDO squares are simple. They are some of the most complicated financial instruments in the history of mankind, and you expect simple rules to kind of keep them in check. I don't get it. You have a complicated, difficult, always advancing, always changing financial services market. You are going have to have complex rules to try to catch up—never get ahead, but just to catch up.

And, honestly, it would help me a lot if anybody ever came to talk to me about a complex rule who didn't always come to me to complain about any rule. I would love to be here at a panel with people subject to regulations, who told me, "That is a fair and reasonable regulation." I have never heard that in the 14 years I have been here.

So I will, kind of, start off with difficult stuff to comprehend.

Mr. Robertson, your $1 trillion number, it is a big number, a scary number, but I have some other numbers. GAO says that the financial crisis wiped out $9 trillion of assets. GAO says that it reduced economic output by $12 trillion. The TARP that we passed was just short of a trillion dollars. The Federal Reserve increased its balance sheet by a trillion and a half. All total, that is $23.2 trillion that were either lost or put on the line because we didn't have sufficient regulations at the time.

Now, I don't know about anybody else, but my concern is that we have adequate regulations going forward. I totally agree, and I have been saying from day one, this regulation, all regulation—I know that the other side likes to pretend that we are all for overregulation. That is my platform: I am here to kill business because I hate jobs. That is ridiculous.

We are looking for balanced regulation, and not for the normal players but to try to somehow cow the outliers. Now, whether this particular regulation hits the mark or not will tell over time, and if it doesn't, we will amend it, like it has already been amended even before it is implemented.

Mr. Bentsen, you pointed out some very interesting comments that might be of concern to me as I check them out. And if they work out, if I agree with them, which I tend to on their face, I will try to help you address those. Those are fair points.

But for me, it is really only about one thing. As I see it, the whole crisis was caused because we had the financial institutions, the biggest ones, taking risk that they had insufficient capital reserves to cover. That is the bottom line. I don't care that somebody is gambling their own money, and if they lose it—but when they do it in a way that then puts my mother's pension at risk, that is a problem, and we have to do something about it.

So, yes, is it any surprise, is it wrong that we are asking some of the people who were making some of the riskiest bets to increase their capital reserve? Now, whether $1 trillion is the right number, that is a fair question.

Mr. Robertson, do you think that we should actually ask anyone to have any capital reserve ever?

Mr. ROBERTSON. Absolutely.

Mr. CAPUANO. So now the question is, how much?

Mr. ROBERTSON. Exactly.

Mr. CAPUANO. And that is a fair question. Is $1 trillion too much? Maybe. What is the right number? Half a trillion? $700 million? I don't know. But that is what we are here for, to try to get it right.

The one thing I know without question, without doubt, without debate is that it was insufficient in 2008. Does anyone disagree with that? Do you think that we had sufficient capital requirements in 2008? Because if you do, please raise your hands, because I would like to hear more.

So we all agree that they were insufficient and we have to increase them. How much? Anybody here have the answer? Because if you do, I want to hear it. I am not sure.

Mr. JOHNSON. Congressman, I think they should be increased by much more than currently proposed.

Andrew Haldane of the Bank of England recently said that the way to think about capital on a global basis in the largest financial institutions is that they were—capital requirements on a leveraged basis were between 1 and 2 percent. So you could be 98 percent leveraged, 98 percent debt or more. Now, under this Basel III agreement as applied in the United States, we will get slightly over 3 percent capital requirement, so you can be nearly 97 percent debt.

I don't think that is enough to withstand the kinds of risks that you are identifying.

Mr. CAPUANO. So I should continue being nervous, which I guess I am.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Texas, the Chair of our Housing and Insurance Subcommittee, Mr. Neugebauer, for 5 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. And I appreciate the panel being here.

I think my biggest concern, whether it is the Volcker Rule or all of these regulations is, one, the lack of cost-benefit analysis that has been done. Because ultimately, who is going to pay for these increased costs are the people who are at the bottom of the chain here, and that is the customers of, for example, Mr. Funk's bank.

Mr. Funk, how long have you been in banking?

Mr. FUNK. Excuse me?

Mr. NEUGEBAUER. How long have you been in banking?

Mr. FUNK. This is my 34th year.

Mr. NEUGEBAUER. Yes. It has changed a little bit in 34 years, hasn't it?

Mr. FUNK. That is a fair statement.

Mr. NEUGEBAUER. Yes. I have been a banker, and I have been a borrower, and over the years, how I did financial transactions changed a lot.

And one of the things that I was concerned about is that as your bank has grown, you have had customers grow, as well. And, at some point in time, those customers grow to the point where you are maybe not able to handle all of their financial needs.

And so, then, if you are doing your job, and I am sure you are, your job is to create ways to—free up ways to continue to lend to them or make sure that your customers' credit needs are fulfilled. Is that correct?

Mr. FUNK. That is correct. And what we usually try to do in those instances is bring other community banks into the group and satisfy them, and these customers still remain our customers.

Mr. NEUGEBAUER. And, in some cases, you can free up capital in your bank by taking advantage of some of the products, for example, that Mr. Ganz has been talking about, where securitizing, say, auto loans or packaging some commercial loans, whether you are doing it by bank participation or by securitizing those. Is that correct?

Mr. FUNK. That is correct.

Mr. NEUGEBAUER. Yes. I think the question that I have is, based on your initial blush of looking at how all of the capital markets are—because the direct lending from banks to businesses is actually declining. So how do you see the Volcker Rule impacting your ability in the future to be able to be creative with some of your customers?

Mr. FUNK. I think that is a great question. And I think, to go back to the point that before December 10th I didn't pay much attention to the Volcker Rule because I was told it didn't affect community banks, we understand the Volcker Rule is the law. We understand that it was designed to reduce or eliminate proprietary trading for systemically important banks. There is no way you could make an argument that MidWestOne Bank in Iowa City is systemically important, and yet we have seen the effects over the last 30 days, and it wasn't been too pleasant for some of our people and our board as we have tried to grapple with the new rule.

And, again, we thank you for all the support in getting that changed. It is fair to say that things usually don't get changed that quickly. So the fact that you were willing to weigh in is very good, but what happens the next time if we can't get a decision that quickly and we have to recognize those losses? So it is the unknown, Congressman.

Mr. NEUGEBAUER. Thank you.

Mr. Bentsen, one of the things that allows financial institutions to do some of the kinds of lending that they do today is being able to hedge some of those risks and to balance the risks that they are taking as a financial institution.

And I think you kind of alluded to the fact that this Volcker Rule could impact the banks' ability to really actually effectively manage their risk, which is kind of counterproductive to what, hopefully, regulation is about. Regulation is about stabilizing the ability of a financial institution to manage their risk so that they are not systemically risky.

But in many cases, if we are going to limit their ability, won't that have an impact on them?

Mr. BENTSEN. That is a good point, Congressman. Time will tell. And, I think some time ago there were five or six regulators sitting at this table who were talking about the importance of hedging as a risk-mitigating regulatory tool. And I think the regulators certainly had that in mind when they were trying to write this rule.

And to Professor Johnson's point, the proposed rule that we dealt with was one thing, and we had to look at that as to what that might be as a final rule. We now have a new rule with 900-plus pages and then we try to interpret that.

So time will tell as the conformance period ends, firms begin to implement, and they understand what the compliance rules are, their compliance and enforcement liability. Then I think we will see the impact as it relates to hedging, market-making, and other permitted activities.

Mr. NEUGEBAUER. But I think we can all agree that because of this new rule, pricing will have to be put in place for the regulatory risk of whether you are in compliance are not and all of the steps—

Mr. BENTSEN. It won't be free, you are right.

Mr. NEUGEBAUER. Yes.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Massachusetts, Mr. Lynch, for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman.

I want to again thank the panelists for your help with doing our work.

And I do agree, the specifics of this rule are complex, but I think at its core is a very simple idea, that banks of any size should not be allowed to use taxpayer-backed support to make risky or reckless bets for their own profit. That is the basic idea underlying the Volcker Rule.

And, to that end, the Volcker Rule prohibits banks with FDIC-insured deposits or access to the Fed's discount window from engaging in risky proprietary trading. We just believe that is not something that the United States Government needs to be subsidizing. That is the simple idea behind the Volcker Rule.

Now, this should be something we can all agree on, but unfortunately, I think this commonsense reform has been fought tooth-and-nail by Wall Street banks and their allies. And I understand why. We all understand that proprietary trading is incredibly profitable for Wall Street banks. But just because something makes Wall Street a lot of money doesn't mean it is a good thing for the American people.

And let me take a moment just to address one statement that has been made repeatedly, including today—I heard repeatedly that proprietary trading did not cause the financial crisis. And there are all kinds of people cited as saying that. But let's go back to the facts here.

The investment bank Bear Stearns, for starters, started its nosedive when it was forced to bail out two of its hedge funds that had made highly leveraged proprietary trades in subprime mortgage securities. That is when Bear Stearns went in the toilet. Less than a year later, Bear Stearns was sold for pennies on the dollar to JPMorgan to avoid bankruptcy. That is example one.

Citigroup was forced to bring 7 investment funds it sponsored with big proprietary bets in the subprime mortgage market onto its balance sheet, assuming $58 billion in debt. And less than a year later, Citi received multiple bailouts, including the TARP bailout from the Federal Government—which I voted against—without which it would not have survived.

Finally, Lehman Brothers, remember them? They made a huge, risky proprietary bet in the same subprime mortgage market based on their analysis that the bets that they made would be profitable for the bank—for the bank, not for its customers, but for the bank.

In September of 2008, when those bets went south and Lehman could no longer get funding for its day-to-day operation, it was forced to file for bankruptcy.

These massive proprietary bets made in the subprime mortgage market sent shock waves through the market and drove our economy to the brink of collapse. Those are just the facts. Proprietary trading and sponsorship of exotic investment funds that enabled proprietary trading by banks were absolutely a leading cause of the financial crisis. And I applaud the regulators for putting a strong Volcker Rule in place to try to prevent this type of risk-taking going forward.

Now, I heard from the panelists, and I can't remember who, I think it might have been Mr. Robertson who complained that there wasn't enough comment period on this rule. But just for the record, there were 18,000 comment letters which were submitted to the regulators in coming up with this rule. We had 111 stakeholder conferences. We began the discussion of Section 619 in July 2010. It took 3½ years to talk about it. We talked this thing to death.

So, I just bristle at the idea that we did not spend enough time on this and that the financial industry did not have enough input. There was, from the outset, an effort to either kill it or delay it until it died a slow death.

So, look, we know why folks want to kill the Volcker Rule, but, in all honesty, I think it is a good step. Can we tweak it a little bit, and like we did with the trust preferred securities (TruPS), can we make sure that the unintended consequences, if any, are mitigated? Sure, we can do that. But make no mistake: We need this.

And if we are talking about job creation, and we are—the title of this hearing is about how the Volcker Rule might hurt job creation—let me go back over the effect on job creation of not having the Volcker Rule.

Let's go back to September of 2008, when this started in earnest. We lost 435,000 jobs that month; the next month, 472,000 jobs; the next month, November, 775,000 jobs were lost; December, 705,000 jobs were lost; the next month—there is nothing there that dipped below a loss of 700,000 jobs for the next 6 months. So that is the impact on job creation of not having the Volcker Rule.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from North Carolina, the Chair of our Oversight and Investigations Subcommittee, Mr. McHenry, for 5 minutes.

Mr. MCHENRY. I want to thank my colleague on the other side of the aisle for bringing up those issues. It sounds like it is not really Volcker that he is talking about, because Bear and Lehman didn't have a single deposit; they are not depository institutions.

So the concerns that he raises are genuine ones and concerns that we have raised in a series of hearings on too-big-to-fail in the Oversight Subcommittee that the chairman has directed. And the concerns we—

Mr. LYNCH. Will the gentleman yield?

Mr. MCHENRY. —raise as a question of this is the scheme that Dodd-Frank puts in place that does not end too-big-to-fail.

Mr. Johnson, would you agree with that concern we have, that Dodd-Frank does not end too-big-to-fail?

Mr. JOHNSON. Too-big-to-fail is still with us, Congressman. But, unfortunately, all of what we have previously known as investment banks have now converted to become bank holding companies.

Mr. MCHENRY. Exactly. And we have talked about that.

Mr. JOHNSON. And that is an important part of the issue. That is why I agree with Mr. Lynch that these things are bundled together on a forward-looking basis. Whatever you think happened in the crisis—

Mr. MCHENRY. Right.

Mr. JOHNSON. —it is all bank holding companies now.

Mr. MCHENRY. But Volcker actually doesn't end up protecting the taxpayer, which is a genuine concern I have, that institutions, private-sector institutions, when they fail, the taxpayers are on the hook for it.

And, look, we have had good conversations about this, as well. But the question I have for the panel today is: Can you put a dollar amount on the cost, the economic consequence of Volcker as is now set in stone by the regulators?

Mr. Bentsen, do you have a dollar amount?

Mr. BENTSEN. No, sir, we can't, because we are—

Mr. MCHENRY. Okay.

Mr. Funk, do you have a dollar amount?

Mr. FUNK. No, sir.

Mr. MCHENRY. All right.

Professor Johnson?

Mr. JOHNSON. Yes, Congressman. I thinks it is part of what is being displayed on the wall here. According to the Congressional Budget Office, the effect of the financial crisis is to increase our debt over the cycle—

Mr. MCHENRY. Sure.

Mr. JOHNSON. —by about 50 percent—

Mr. MCHENRY. No, no. I am asking—

Mr. JOHNSON. —five-zero percent of GDP, half of GDP, call that $8 trillion, because of the financial crisis and the depth of the recession that created.

Mr. MCHENRY. So Volcker—

Mr. JOHNSON. The Volcker Rule addresses precisely the way in which these largest bank holding companies, as they are now, can take risk, can disrupt the economy. Their ability to do this—

Mr. MCHENRY. I understand. I have limited time, and the chairman is using the gavel today, actually, very well. I am glad I got to ask a question before noon.

But to your point, Professor Johnson, for me as a policymaker, I can't simply say, well, Volcker just saved us $8 trillion.

Mr. Ganz, do you have a dollar amount?

Mr. GANZ. The dollar amount I have is $7 billion if the market moves 10 percent. It could be greater than that. But that is the amount that it would impact the CLO market unless there is some remedy very, very quickly.

Mr. MCHENRY. Okay.

Mr. Robertson?

Mr. ROBERTSON. There is absolutely no way to put a dollar figure on it.

Mr. MCHENRY. Okay.

So part of the concern is this: We have as a matter of the Securities and Exchange Commission written policy that they will have a cost-benefit analysis before they codify rules. We have had a lot of good ideas across the whole panel here today on ways to improve the Volcker Rule as it is written, if it is going to be there. There are some genuine concerns that we can mitigate the downside on this. And yet, at the same time, if we had an interim final rule, we could resolve these things without—in realtime market consequences in the way that, in the rush of these five regulators to get things done, they have done.

And the rush was to get the rule done, codified, and rolling, and then try to tweak it in realtime. The TruPS issue is a great example of this.

So I have an additional question. Mr. Bentsen, who is the primary enforcer of Volcker?

Mr. BENTSEN. There is not a primary enforcer, in our view. There are five enforcers, and maybe six if you add FINRA to the mix, which I think ultimately the SEC will look to FINRA to do.

Mr. MCHENRY. Mr. Funk, as a bank, you have plenty of regulators, right?

Mr. FUNK. We are a publicly traded bank, so, for us, we have three: the SEC; the FDIC; and the Federal Reserve.

Mr. MCHENRY. Okay.

So, Professor Johnson, in this final moment I have, as we said, too-big-to-fail is still with us. You have been an advocate of simplicity—simple institutions, simple regulations, what is happening in Great Britain and what Andy Haldane has done in terms of this discussion on simplicity.

This is a complex rule. Do you think that there is a better approach to this? What you said is this provides a "good chance" that it will reduce risk. You are really not willing to go on the line and say this absolutely will reduce risk. You are saying it has a good chance.

Chairman HENSARLING. Briefly.

Mr. JOHNSON. I think it depends on the implementation. I worry a lot about this number up here. And I don't understand, Congressman, why you, with your justified concerns about this number, cannot draw the link, the very obvious link, between the depth of financial crisis in the future and the—

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Georgia, Mr. Scott, for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman. I appreciate it.

The one concern I have about the Volcker Rule—first of all, let me say the Volcker Rule is needed. We should not be using proprietary trading. It could form a very unstablizing impact.

But there may be an unintended consequence here, and I want to examine that. And that is in the international arena and how we are placing our economic system in a weakened position if we do not look very carefully at the competitive situation that we place our banking—and not just our banking. Our banking is just one part of it. We have companies and businesses. Ours is not a one-economy-of-the-United-States economy. So it is very important that our banking system not be put in an uncompetitive edge when it comes to dealing in the world markets.

Now, here is what I am talking about. I am a member of the NATO Parliamentary Assembly. I serve on the Economic Security Committee. That is an extraordinary committee. Two or three times a year, we meet over in Europe, and we deal with—75 percent of the discussion is on what is happening in the United States. So, let me just start with that for a moment.

Mr. Bentsen, we have a situation here where there is an exemption for foreign banks and their affiliates from the Volcker Rule as long as they are doing business outside the United States and are not in any way controlled by a U.S. bank. But that is over in Europe. Meanwhile, we have the European Union and we have Great Britain who are forming their own Volcker Rule.

So, in the midst of this, we are placing our economic system and our banking system to operate in this environment. So my point is, is there an area here where there is any unforeseen danger to our impact, our position as the leader in the economic activity of the world? I am very concerned about that. And I have, sort of, a viewpoint, because I have to deal with these other nations.

And not only that, the European Union is just one, and within that are 28, 30 other nations, all with their own. And on top of that, we have McDonald's, we have Google, we have Coca-Cola, we have Delta, we have Deere tractor, Caterpillar. We have huge companies that do business all around the world.

So I think it is very important to get an answer to this question: One, is there something within this Volcker Rule, within the environment and the reaction to it that I just articulated about Europe and about Great Britain, is there something with the exemptions that we are giving them here and the complexity of all of that could put the United States economy in a more vulnerable position?

Mr. Bentsen, will you take a crack at that first?

Mr. BENTSEN. Congressman, yes, that is a very good question.

First of all, the Europeans, either through the EU with the Liikanen study and potential proposals coming after that, the Vickers report, which is now being implemented in the U.K. banking law, activities in Belgium, Germany, and France, are all very different than the Volcker Rule. None of them ban proprietary trading, for starters. They look a lot like the Gramm-Leach-Bliley construct that we have had the United States.

Second of all, you make a very good point, because while the rules as they relate to foreign banking entities that are captured by Volcker in the United States—and we represent many of those in our membership—the rules are murky as to what they can do outside the United States, we believe the biggest concern to the United States is the impact on the depth and liquidity of U.S. capital markets.

While we still are dominant in that field, we don't have the vast majority that we once did. And we expect to see other markets grow. But we know the Asians aren't going in this direction, because they are trying to develop capital markets to sustain their growing economy and move away from a pure bank financing operation. The Europeans are trying to look at their universal bank model and, again, how they get away from just a pure bank balance sheet, or not a pure, but a heavily bank-balance-sheet-dependent, and have more capital markets. Whereas, in the United States, we run the risk of either pushing people out of the capital markets or reducing the depth and liquidity in our markets. And that really affects the people who use it, and those are the issuers and the investors.

Mr. SCOTT. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Campbell, Chair of our Monetary Policy and Trade Subcommittee, for 5 minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman.

There has been a lot of discussion so far about what is in the Volcker Rule. I want to talk about something that is not in the Volcker Rule which seems to be inconsistent to me.

My understanding is that, whereas the Volcker Rule prohibits proprietary trading in private the bonds—so for the private entities. It does not do so for sovereign debt and for public debt, sovereign debt of other countries and for public debt in the United States.

Now, I am from California, and where I sit, it would seem to me that it would be less risky to have proprietary trading in AAA-rated corporate bonds than in the municipal bonds of any number of cities in California or of any number of sovereign debt from any number of countries in Europe.

Is this an inconsistency? Do any of you see that it is okay to do all the trading you want in what are clearly some very risky U.S. Government and non-U.S. sovereign debt?

And Mr. Robertson is, like, champing at the bit on this.

Mr. ROBERTSON. Yes, I do find it somewhat interesting that the municipal debt has been excluded. And if you think about it, it is really the public sector standing up and saying, we think if you allow technically market-making but not trading, that is going to reduce our access to credit.

So it is curious to me that we have decided that proprietary trading has no social good or value in creating liquidity and creating markets, but, with their own actions, the municipalities have shown they don't believe that to be true.

Mr. CAMPBELL. All right. So it is a complete inconsistency, in your view.

Other thoughts or comments on that?

Professor Johnson?

Mr. JOHNSON. My understanding, Congressman, is that foreign debt denominated in a foreign currency is not treated the same way as U.S. Treasury debt. The foreign governments wanted that, they requested it, and they said and some private-sector people said there will be dire consequences if they didn't get it. But the treatment—they did not get—Greek bonds are not being treated the same way as U.S. Treasuries under the Volcker Rule.

Mr. CAMPBELL. No, but I think through a foreign subsidiary they can, though.

Mr. BENTSEN. Congressman—

Mr. CAMPBELL. Yes?

Mr. BENTSEN. Yes, if you are a foreign bank operation in a home country—so a Barclays, who is a U.K. bank, can be proprietary trading gilts through the—

Chairman HENSARLING. Mr. Bentsen, if you could talk a little closer to the microphone there?

Mr. BENTSEN. Yes. Sorry.

There is somewhat of an exemption that was expanded as it relates to foreign banking operations. However, importantly, a number of U.S.-domiciled institutions are also primary dealers in foreign sovereigns like gilts, like JGBs, and others, and they are not afforded that treatment.

Mr. CAMPBELL. Mr. Johnson?

Mr. JOHNSON. I think you should worry, Congressman, precisely about where there is either a residual responsibility to the U.S. taxpayer, hence the debt number, or an impact on the U.S. economy from some sort of investment, speculative or otherwise, in exactly sovereign bonds, foreign sovereign bonds. Because those are much more risky than commonly perceived.

So, to the extent that this exemption becomes what you might call a loophole which poses risk to the U.S. economy, I would worry about it. But we also can't take upon ourselves, unfortunately or fortunately, the role of regulating all of the world's banks.

Mr. CAMPBELL. Does anyone disagree with the view, on this panel, that regardless of where you are on the Volcker Rule, on the proprietary trading in general, that the treatment of corporate debt and of municipal or government debt, be it in this country or—should be aligned?

Okay. There is no—Mr. Bentsen?

Mr. BENTSEN. Congressman, it is a very interesting question. It is a conundrum, no question. I believe policymakers, at the time that they put in the restriction on proprietary trading, obviously had concerns that restriction could have negative consequences for the U.S. Government debt market, for the—

Mr. CAMPBELL. To say somehow it will have consequences on municipal but it won't have consequences on corporate, that makes no sense. Clearly it does, and clearly it was intended that government is virtuous, and therefore their debt, albeit bad, is virtuous, and so it is okay to do proprietary trading there. It just seems wrong to me.

Mr. Johnson?

Mr. JOHNSON. Congressman, you are obviously right. Historically and forward-looking, there are risks in both municipal debt and in corporate debt, and sometimes the risks occur in one sector and sometimes in the other sector, and sometimes they affect the economy.

I would separate out U.S. Treasury debt. I would treat U.S. Treasury debt separately because that has different risk characteristics. But I think to the extent that you are concerned about there being risks and corporate risks in municipal debt, that is obviously what we have seen in the past and what we will see in the future.

Mr. CAMPBELL. Thank you all very much. I yield back the balance of my time.

Chairman HENSARLING. The Chair now recognizes the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. I am wondering a bit why the Volcker Rule applies to debt instruments such as bonds at all. If a bank makes a loan to a business, that is what they are supposed to do. If I understand the Volcker Rule correctly, if they buy corporate bonds of a similar business, that is restricted. The disadvantage of bonds is that your profits and loss are readily apparent to the world every day, whereas if you make a loan to a business, you assume the same risks, but you can keep them hidden. Nobody knows what that loan is worth this day or that day.

I wonder, Mr. Ganz or others, do you have a comment on whether the Volcker Rule should apply to debt instruments?

Mr. GANZ. Sure. The idea behind the section that is on ownership interest was to take what looks like or is called a debt instrument, but really has indicia of ownership like an equity. So, it has some upside. It gets part of the profits. But for—

Mr. SHERMAN. You are talking about convertible debt?

Mr. GANZ. No, I am talking—it is not specific. It just, for example, has the right under the terms of the interest to receive a share of the income, gains or profits of the covered funds.

Mr. SHERMAN. So, participating debt.

Mr. GANZ. Right.

Mr. SHERMAN. So the Volcker Rule applies only to debts that participate in profit, not straight debt instruments.

Mr. GANZ. Exactly.

Chairman HENSARLING. Mr. Ganz, could you bring your microphone a little closer, please.

Mr. GANZ. I'm sorry. The problem for TruPS and the problem for CLOs is that one of the seven indicia of ownership is really not an ownership indicia, it is a debt protection. And that is what is going—

Mr. SHERMAN. What is that one out of seven?

Mr. GANZ. It is the ability to remove or replace a manager for cause. So if the manager gets arrested or does something in violation of the indenture, that is a protective characteristic of a lot of debt instruments.

Mr. SHERMAN. Let me move on. But that seems to be trivial, and I would think they can modify that.

What about the "Hotel California" rule, that if you are covered by the Volcker Rule, and then you are no longer a commercial bank or own a commercial bank, you are still covered by it? Does anybody see a need to let people out of the hotel a few years rather than forever?

Mr. JOHNSON. Congressman, the problem is, of course, that once you extend this protection of the bank holding company status to the investment banks, which was done in the fall of 2008, Goldman Sachs and Morgan Stanley became bank holding companies, that has come historically with a lot of restrictions. We will see what happens going forward.

Certainly Goldman, and I think also Morgan Stanley, said at some point subsequent to that, if you are going to impose the full restrictions of bank holding company status on us, then we don't want to be a bank holding company anymore, we will go back to being an investment bank. In other words, they want full access to the Fed when they need it, but not when they feel it—

Mr. SHERMAN. There is little assurance that we would give it to them again. But if we apply the Volcker Rule to any corporation that has been ever a bank holding company, we could also apply it to any corporation that might in the future become a bank holding company. Yes, Goldman went out and acquired a bank and became a bank holding company. So could Apple Computer tomorrow.

Mr. JOHNSON. Congressman, no. You should worry about—

Mr. SHERMAN. So could many others.

Let me move on to one other issue, and that is we saw with AIG that you can have a highly risky parent owning subsidiary corporations. As long as the subsidiaries are properly regulated, they survive fine. Do we need to apply the Volcker Rule to bank holding companies, or do we just need rules to protect the banks themselves? What risk is there to the U.S. taxpayer as long as the bank subsidiary is safe?

Mr. FUNK. It is my understanding, Congressman, that it does apply to bank holding companies because the Federal Reserve is one of our regulators, and they—

Mr. SHERMAN. Yes, I am asking whether from a public policy standpoint that is necessary.

Mr. JOHNSON. But, Congressman, remember, it was AIG Financial Products. It was a subsidiary of the holding company in London that had the very big losses. So this wasn't a bank holding company situation.

But to take your analogy—

Mr. SHERMAN. But the regulated subsidiaries did fine. The unregulated entities that did not face that level of U.S. insurance—

Mr. JOHNSON. There were huge losses to the group, and it was an impairment to the credit of everyone in that group because of what had happened in this one unregulated subsidiary. So I think going at the bank holding company level makes a lot of sense.

Mr. SHERMAN. Mr. Bentsen?

Mr. BENTSEN. I would just say, Congressman, regardless of Volcker, AIG is now captured under the systemic designation, and so they are regulated at the holding company level, across which they wouldn't have been before.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from California, Mr. Royce, the Chair of the House Foreign Affairs Committee, for 5 minutes.

Mr. ROYCE. Thank you very much, Mr. Chairman. I was going to start with Mr. Bentsen with a question based on your testimony, your opening statement. You mentioned the need for the regulators, the five rule writers, along with the National Futures Association and FINRA to, in your words, coordinate: to be consistent in their interpretation, in their examination, supervision and enforcement of the final regulations.

Is there enough clarity here for the industry on this point? Because what happens if the OCC says certain conduct is acceptable, and then the SEC says no? Or, let us say FINRA has a different viewpoint. How is that handled?

This is one of the concerns we have always had about, when we did have the financial implosion, there was a lot of discussion about trying to set up a world-class regulator that could call the shots and make the decisions. You would have a primary regulator that could do all of this. This is a very different environment. Let me hear your thoughts on that.

Mr. BENTSEN. Thank you, Mr. Chairman, for that question.

The rule in no way states how the regulators are going to coordinate. In fact, it acknowledges that there is not a method or protocol for doing that, and acknowledges that there is overlap in jurisdiction. So we think it is very lacking in that respect.

We actually in our comment letter suggested that perhaps the Federal Reserve should act as the lead regulator since Congress gave them the ability to extend the conformance period since you were amending the Bank Holding Company Act. But there is no mechanism, no protocol, and as a result of that, our view is based upon the underlying statute that it really should be the role of the FSOC now to step in as they have under their mandate to act as the coordinating body to put that in place.

Mr. ROYCE. Any other views by other members on the panel on this?

Mr. FUNK. Mr. Chairman, I would say from the ABA's point of view that we recognize there will be times when there are different sets of rules, and we would welcome some way for clarity to come to this process where they all apply rules the same way, and if that has to come from Congress, we think that is a good solution. But we don't think you can have five sheets of music, because some of our members are regulated by all five, and if the rules are interpreted differently, I think that is a real problem.

Mr. ROYCE. Let me ask Professor Johnson.

Mr. JOHNSON. Sir, I think, Mr. Royce, you raised a very good issue. The Financial Stability Oversight Council was created specifically to try and bring better coordination across these disparate agencies, and the Chair of that is the Secretary of the Treasury. And I think the Secretary of the Treasury should have a responsibility for making sure that they are all on the same—using the same sheet of music. That is a very reasonable request.

Mr. ROYCE. Rather than the Fed taking the lead on it? Or what—

Mr. JOHNSON. That is a great question you could debate for a long time. The Chair of the FSOC, eventually that job went to the Secretary of the Treasury, so that is the logical place to ask for better coordination on specifically this kind of issue.

Mr. ROYCE. Mr. Ganz?

Mr. GANZ. We agree. The issue that we are dealing with now is a perfect example. We are asking for an FAQ, something really, really simple. We have to go to—we apparently have to go to five agencies, one of which has really nothing to do with the product—loan product at all, the CFTC. So that is incredibly cumbersome, and a streamlined process would be very helpful.

Mr. ROYCE. And lastly, Mr. Robertson, your commentary.

Mr. ROBERTSON. I think there is the need to better coordinate regulation, and we are even seeing regulation coming down the pike that is conflicting with other regulations. So it is creating a lot of complexity for all constituents in the financial system.

Mr. ROYCE. And then I am sure this issue has been asked, but I saw that CalPERS out in California raised the concerns, the same issue really about regulation: How do you make sure it is consistent? But they are making the point of global regulation on this issue. Just a quick commentary on that.

Mr. BENTSEN. Mr. Chairman, as I stated earlier, while other jurisdictions in Europe are talking about changes in bank structure, going from looking at the universal bank model that you know that they have in Europe, Liikanen and Vickers are really more in line with what I would call the Gramm-Leach-Bliley construct than a ban on proprietary trading, the more ring fencing or separate operating subsidiaries or affiliates. And in Asia, frankly, they are trying to develop their capital markets out there, and so they are not moving in this direction at all.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Texas, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I thank the witnesses for appearing, and, if I may, I would like to single out my friend, the Honorable Ken Bentsen, who was a U.S. Representative from the State of Texas, in fact for some of the area that I currently represent. Thank you for appearing today. Also, I would like to congratulate you. I think the last time you were here you did not hold the title of president and CEO. I think you have been promoted since we last saw you. So, congratulations. And by the way, I am not going to say congratulations and then say, now let's get on with it. I do want to talk with Mr. Johnson for just a moment.

Mr. Johnson, should there be some limitation imposed upon banks in terms of proprietary trading, in your opinion?

Mr. JOHNSON. Yes.

Mr. GREEN. Should they be allowed to use taxpayer dollars? Should there be some limitation on tax dollars that are—consumer dollars that are in banks which are backed by the Federal Government? Should there be some limitation?

Mr. JOHNSON. Yes, Congressman, there should be some limitation on the proprietary trading activities of the largest bank holding companies in this country.

Mr. GREEN. Is it true that this is what the Volcker Rule seeks to do?

Mr. JOHNSON. That is absolutely the intention originally of Chairman Volcker, and of the legislation from Congress, and what the regulators worked on for nearly 4 years.

Mr. GREEN. Now, do this for me. We have talked a lot about proprietary trading, but we haven't taken just a moment to let the public know what proprietary trading really is. Would you please give us a definition of "proprietary trading?"

Mr. JOHNSON. Congressman, the term "proprietary trading" in this context means an investment made by a bank holding company for the purposes of betting, for the purposes of getting some capital appreciation. They are not buying a security in order to sell the security as part of market making—

Mr. GREEN. Who is to benefit from it? Who is to benefit from that trade you that just called to my attention?

Mr. JOHNSON. The people making the trade within the bank, and executives of the bank, and perhaps the shareholders of the bank.

Mr. GREEN. Will the customer who has a deposit, will that person benefit from the proprietary trading, directly benefit from it?

Mr. JOHNSON. Assuming that there is no direct positive impact on the customer, and, as has been flagged already in the hearing, there may be conflicts of interest. There are certainly documented cases where it has arisen that the bank has been trading in its own interests on a proprietary basis, and that has been a conflict of interest with business they are doing for the customer.

Mr. GREEN. So what we have is this: We have a bank that takes some of its customers' dollars, and it uses those dollars to engage in this thing called proprietary trading, which is using the dollars to benefit shareholders in the bank, the bank itself perhaps, but not those customers. Is that correct?

Mr. JOHNSON. That is correct. That was the structure, for example, of JPMorgan's so-called London Whale proprietary trading.

Mr. GREEN. And do you think it is unreasonable to want to curtail the amount of dollars that are proprietary, that are traded in this fashion so that customers don't end up at some point suffering? We don't know that it will happen, but it could happen. Are we trying to protect the customers of the bank?

Mr. JOHNSON. We are trying to protect the customers, but we are also trying to protect the taxpayer. Remember, Congressman, many times these bets don't work out very well. They turn out not to be profitable. The expectation is they will make a profit, but they are very risky. So sometimes they get the negative downside on those bets. They lose. Who is on the hook for the losses? If it is a big bang holding company, one of the largest, there is a government backstop through the Fed and other ways, and that is the taxpayer ultimately.

Mr. GREEN. Does the Volcker Rule prevent banks from using other capital to engage in proprietary trading?

Mr. JOHNSON. The Volcker Rule as designed restricts the amount of proprietary trading that banks can do, both using customer funds and, for example, going out and borrowing additional money with which to speculate.

Mr. GREEN. Exactly. But are there other funds that they can use?

Mr. JOHNSON. Again, in principle there are restrictions on their ability to make these speculative investments and therefore to fund investments with funding sources of any kind.

Mr. GREEN. Is it the opinion of any one of you, dear friends, that the Volcker Rule should be completely eliminated? If so, would you kindly raise your hand? I have heard your testimony, but I just want to make sure I understand. Is there anyone who thinks it should be completely eliminated? If so, raise your hand.

Let the record reflect that no one has indicated that it should be completely eliminated.

Mr. BENTSEN. Congressman Green—

Mr. GREEN. Let me do this. I only have 12 seconds, and I will come back to you in about 3 seconds. But quickly now, tell me this: Do you think that we can tweak it, we can mend it rather than end it, and it can be a benefit to us? If so, would you kindly extend your hand? This time, I want affirmative action.

All right. I see three persons. So should I conclude we have other persons who don't—

Chairman HENSARLING. The Chair has concluded that the time of the gentleman from Texas has expired.

Mr. GREEN. Thank you. And, Mr. Chairman, I would now ask that my friend be allowed to respond.

Chairman HENSARLING. The Chair now recognizes the gentleman from Wisconsin, Mr. Duffy, for 5 minutes.

Mr. DUFFY. Thank you, Mr. Chairman.

I want to follow up on a question that Mr. McHenry had been asking, and it goes to the cost looking forward of Volcker. And I guess I would ask you, Mr. Johnson, looking forward, I know you pointed to the debt screen, but looking at its impact on our economy, impact on our capital markets, do you know the cost of that? Do you have an assessment of that cost?

Mr. JOHNSON. So the cost that we see now, Congressman—and I am looking at the testimony that has been provided to this committee and from other industry experts where they predicted certain outcomes, and I am looking to see whether these have actually transpired. The cost to the economy, which is the way you framed it, the right way to frame it, is very, very small. Now, there are adjustments still to be made, and that is what we are talking about today. But in terms of lost economic output, in terms of lost debt for the capital markets, in terms of any of the other concrete, specific costs that have been floated or suggested hypothetically, I am afraid I don't see them. I have not seen independent analysis that really quantifies those.

Mr. DUFFY. And I would agree with you. I haven't seen that analysis either, because the writers of the rule didn't do a cost-benefit analysis, which is one of our concerns. Just like the CFTC and the SEC do, so, too, should the rule writers so we could actually take a look in a little more in-depth way on the cost of this. And I am sure those who are involved in the CLO market space will think the consequence of the rule is pretty profound.

Does the rest of the panel think that a cost-benefit analysis could have helped hone the rule and left us with a better product? Mr. Bentsen?

Mr. BENTSEN. Absolutely.

Mr. DUFFY. Mr. Funk?

Mr. FUNK. Yes.

Mr. DUFFY. Mr. Ganz?

Mr. JOHNSON. Congressman, you would also have to include the benefits. So it is not the cost, it is the cost and the benefits that you need to include, including the reduction in systemic risk and what that does for the economy.

Mr. DUFFY. Thank you.

Mr. Ganz?

Mr. GANZ. Yes, absolutely.

Mr. DUFFY. Mr. Robertson?

Mr. ROBERTSON. I would say yes, and I think there are two costs and potential benefits. But the costs are not only what would this do to the economic activity, but there are also costs that are going to increase the financial costs of running different entities that will be passed on to consumers and corporations.

Mr. DUFFY. Yes.

Is it fair to say that the securitization markets were explicitly excluded from Volcker and Dodd-Frank?

Mr. BENTSEN. Congressman, no, they were not. Securitization in some form was excluded, but securitization is captured in others, as Mr. Ganz has raised and others have raised. And then, of course, there is a whole section of Dodd-Frank that deals almost explicitly with securitization, starting with QM to QRM to risk retention. And so—

Mr. DUFFY. But with regards to Volcker, Mr. Ganz, were you surprised to see CLOs included in the Volcker Rule?

Mr. GANZ. In the original proposal we were very surprised, especially since there was a rule of construction that was meant to carve out securitizations, particularly of loans. I think the legislative history reflects that this was targeted towards private equity and hedge funds. Asset-backed securities are neither of those. So, yes, we were surprised to see that.

Mr. FUNK. If I could add, I saw a letter yesterday written by the management team of a $20 billion community bank, a large community bank, in the Northeast, and that $20 billion bank has a $360 million CLO portfolio that they will have to divest. And that is part of their core operating business, and that is $360 million that someone is going to have to borrow someplace else. And I don't think—getting to the Volcker Rule, that bank is not systemically important, and the CLOs are not systemically risky.

Mr. DUFFY. Because CLOs didn't have—they weren't the cause or a big part of or a little part of the financial crisis, were they?

Mr. FUNK. Not with this bank, no.

Mr. DUFFY. If you will look at our global marketplace, what other countries have implemented a Volcker-like rule that we can look at and analyze its impact on its capital markets?

Mr. BENTSEN. I would say none.

Mr. DUFFY. Do you guys all agree? There is none, right? We are the first ones.

Mr. JOHNSON. Is that a bug or a feature, Mr. Duffy? Are we supposed to wait for the Europeans to sort out their financial system, which is a complete disaster, or to follow one of these Asian routes with a lot of State subsidies, or to try to back away from the taxpayer support—

Mr. DUFFY. Maybe if we had we done a cost-benefit analysis and gone through the appropriate steps to look at the impact on our capital markets, we might feel a little more comfortable.

Mr. Bentsen, is it going to affect America's ability to remain competitive, whether it is in our banking space or in our small business, medium business, large business space?

Mr. BENTSEN. Our biggest concern is if the regulation, the compliance burden of the regulation is so onerous, and we don't know yet as we are going through this, that it causes firms to pull back from commitment of capital to market-making activities, that will affect the debt liquidity of U.S. markets to the detriment of the issuers and investors who rely on it.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Minnesota, Mr. Ellison, for 5 minutes.

Mr. ELLISON. Thank you, Mr. Chairman, and Ranking Member Waters. I appreciate the time. Also, I want to thank all of the witnesses today for helping us to understand things.

I might just ask generally, this may be—the Volcker Rule may be unique to the United States, but I would imagine there are a lot of other rules that other countries have that you may not want, and I doubt you would ask us to follow them. Like, for example, how many of you are in favor of financial transactions tax?

Okay. So I guess being first is not always a bad thing.

Let me ask you a few questions, Mr. Bentsen. Again, thank you for your work. Thank you for helping us understand the issues today.

In my district, the Fifth District of Minnesota, we are still reeling from the financial crisis. It hit us really hard. We had about 35,000 foreclosures in Hennepin County between 2007 and 2014. Home prices fell 16 percent. Our rental housing market is the tightest in the Nation. And I served on this committee when we passed the Dodd-Frank bill, and the creation of the CFPB, regulation of swaps market, implementation of the Volcker Rule are all critical reforms that we tried to put in place to prevent that calamity from which average Americans are still reeling. We still have 7 percent unemployment.

So I have been a little bit worried about certain elements, not all, I don't want to paint with a broad brush, but some players in the financial services industry, again not all, who appeared to be resisting reform at every turn. In fact, there is an article about it that I would like to have entered into the record. It is a March-April 2013 Washington Monthly article entitled, "He Who Makes the Rules." This article describes, again, certain players in the financial services industry and their litigiousness and their just straight-up resistance and obstinance to commonsense regulation.

I notice that SIFMA has filed a lot of lawsuits, including against the CFTC, saying it lacked the authority to establish position limits despite Congress' clear requirement that it do so. SIFMA also sued Richmond, California, for thinking about eminent domain to address their underwater mortgage situation. And also since the financial crisis, I guess I am curious, how many lawsuits have you guys filed since the financial crisis?

Mr. BENTSEN. First of all, SIFMA did not sue in the case of Richmond, California.

Second of all, in the case involving position limits—

Mr. ELLISON. I don't want to go through the cases. I just want to know how many lawsuits you filed.

Mr. BENTSEN. I just want to say that actually—

Mr. ELLISON. Excuse me, Mr. Bentsen. I certainly want to hear what you have to say, sir, but as you know, time is very limited. You and I could have a more extensive conversation offline, but right here, right now, I need you to answer my question. How many lawsuits have you guys filed on financial regulation?

Mr. BENTSEN. SIFMA has been a party to two lawsuits related to financial regulation.

Mr. ELLISON. I appreciate that.

Do you guys plan to sue over the Volcker Rule?

Mr. BENTSEN. We have no plans to sue over the Volcker Rule.

Mr. ELLISON. Okay. Let me ask you this. I read your testimony, and I thought it was very interesting. And I guess the basic tenor of your message is that the Volcker Rule is just too complicated to implement. Now, I want to ask you, is this a matter about how complex and complicated it is, or do you disagree with the Volcker Rule in principle?

Mr. BENTSEN. We disagree with the Volcker Rule in principle. We state that up front. But we did not say—and if you interpreted that, then we didn't write it correctly. We did not say that it is too complicated to implement. We said it is extremely complicated, and how it is implemented is very important.

Mr. ELLISON. So when Mr. Green asked everyone to raise their hand, notwithstanding your suggestions about what we may or may not do to make it better, who would repeal it, who would not repeal it, you kind of lifted your hand up. Everybody else said that they would be willing to try to work with it in some form or fashion. But you really are just against it, and I appreciate your candor.

Mr. BENTSEN. Congressman, if I may, the point I was going to make to my dear colleague and friend from Houston, my fellow Houstonian had raised is that we were very clear from the very beginning that we did not believe that the Volcker Rule was part and parcel to the financial crisis. We have a disagreement. We agree with Secretary Geithner's comments and Mr. Volcker's comments with respect to that, and we made that clear. But it is the law of the land, and our members are moving forward to comply with it.

Mr. ELLISON. Let me ask you this: Do you think that it is good practice for a financial institution to use taxpayer-subsidized money to engage in proprietary trading? I am sure you have a bunch of—you don't think we should have a rule, but do you think it is good practice or not?

He should be able to answer, Mr. Chairman.

Mr. MULVANEY [presiding]. I am going to cut him off there. The gentleman's time has expired. The gentleman's item will be accepted into the record. Without objection, it is so ordered.

If the gentleman from Virginia would like to allow the gentleman to answer, that is fine.

The Chair now recognizes the gentleman from Virginia, Mr. Hurt, for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman.

I want to thank you all for appearing before us today on this very important issue.

My congressional district is in rural Virginia. I represent everything from North Carolina all the way up to Fauquier County. We have 22 counties and cities. We have many, many Main Streets all across Virginia's Fifth District, so we don't represent big Wall Street firms. My district is, like I said, rural. We have a great interest in consumer protection.

And I know that in the aftermath of the economic crisis, there was a lot of concern about consumer protection, what do we do to protect the consumer, but when I look at some of the unintended consequences of Dodd-Frank, some unintended, some intended, although I would admit certainly all with best intentions, good intentions, I think that what we have seen is that consumers aren't protected, but in many instances consumers are ultimately harmed because of the weight of many of these regulations that result in reduced choices and increased costs.

I think that you can see that when you look in the broad picture, the accumulation of these regulations as it relates to community banks, for instance. If you look, I think in the last 30 years, we have reduced the number of community banks that we have in this country by half. We have gone from 16,000 to 7,000. And I think that is a reflection—you can't blame that all, obviously, on Dodd-Frank, but I do think it is a reflection of, again, the accumulation of the regulatory structure.

I guess my question is—and I would love to have Professor Johnson and then Mr. Bentsen and Mr. Funk answer this question in that order—is there a concern and are you aware of any analysis that has been performed on the potential impact on access to capital for nonfinancial small and midsized businesses with the confluence of the Volcker Rule, the implementation of the Basel III standards, new derivative regulations, and the SEC's impending money market regulations? Are we concerned about the aggregate, and do we know, do we have any idea what the effect of those would be?

And I wonder also this: Isn't it incumbent upon the individual agency that promulgates these rules to be concerned about where their rules fit in the panoply of rules that are obviously increasing the weight for these businesses?

Mr. Johnson?

Mr. JOHNSON. The agencies certainly should be concerned, Congressman, with all of those issues, and the questions you raised are very good questions. What is the impact of this big change in the way we oversee the financial system, both nationally and internationally.

Mr. HURT. Do you think the agencies should conduct a cost-benefit analysis on each rule?

Mr. JOHNSON. Congressman, there are very specific legal requirements for agencies. I am not an expert on those. Let me speak from the economic point of view.

The reason we have this long and large comment period was precisely so that many different stakeholders, both from within the industry and from elsewhere, could articulate precisely what you are concerned about and tell the agencies what the costs will be, some of which they may be able to imagine, and some of which they haven't fully anticipated. That is a very good process we have in this country. Many other countries, most other countries do not have such a public comment process.

I don't promise you that we get to one definitive number. It is a very complex world in which we live. But, yes, we have narrowed down the possibilities, and we have converged on a set of rules that are unlikely to have—

Mr. HURT. Thank you. Let me get to Mr. Bentsen, just so he will have time to answer.

Mr. BENTSEN. Congressman, first of all, let us say from the capital standards, we agree that capital standards needed to go up, and they have gone up about 400 or 500 percent since the crisis, but it is also a fact that capital is not free, and it has—and the price of capital has an impact on the price of credit and capital to the end user. So, there is no question about that.

Second of all, enhanced compliance burden will also have an effect on price, and it could have an effect on liquidity and availability.

So these will have an effect. We don't know yet, but they will have an effect.

Mr. HURT. Thank you.

Mr. Funk?

Mr. FUNK. I think your question was about the cumulative effect of regulation, and in the time I have, I would like to tell you, the footprint of our bank would fit well in your district. We are in North English, Iowa, the only banking office in town. We are in Melbourne, Iowa, the only banking office in town. We are in Sigourney, Iowa. There are only two banks in Sigourney, Iowa.

Our company's employment 2 years ago—3 years ago was about 380 people. It is still about 380 people, but we have added between 6 and 8 positions just to deal with compliance, which means that is 6 to 8 fewer people out in the community serving our customers. And I think that is the answer I have on compliance.

Mr. HURT. Thank you, Mr. Funk.

I think my time has expired. Thank you, Mr. Chairman.

Chairman HENSARLING. The Chair now recognizes the gentleman from Colorado, Mr. Perlmutter, for 5 minutes.

Mr. PERLMUTTER. Good afternoon, gentleman. Thank you for your testimony. And thanks for staying here so long.

I do want to ask unanimous consent that the Bloomberg Report of January 13, 2014, be introduced into the record.

Chairman HENSARLING. Without objection, it is so ordered.

Mr. PERLMUTTER. This is what it says, the beginning sentence: "The U.S. posted a record December budget surplus as higher payroll taxes, payments from Fannie Mae and Freddie Mac, and a declining unemployment rate helped improve the government's finances. Revenue exceeded spending by $53.2 billion last month compared with a $1.19 billion deficit in December 2012."

So now, I kind of want to do a little history lesson, because as I see you, Mr. Bentsen, and you, Mr. Funk, sitting next to each other, there is the old saying that politics makes for strange bedfellows, but so does finance.

So in 1929, we had a crash. In 1933, the first act of the Roosevelt Administration was Glass-Steagall, separating commercial banks from investment banks and insurance companies, and also creating the FDIC and establishing unitary banking.

Fast-forward to 1999. We have Gramm-Leach-Bliley, which Mr. Bentsen referred to, which more or less eliminated the separation between insurance companies, investment banking institutions, and commercial banks.

Go forward to the summer of 2008. The stock market is at 13,000, okay? Then we have tremendous tumult in every market, both the commercial banking, the investment banking, pretty much everything, so that by March 9, 2009, that stock market had dropped from 13,000 to about 6,500. And it is $1.3 billion per point, so $7-point-something trillion in 6 months lost just in the stock market. Forget about jobs, forget about housing.

So in the course of putting TARP together, the Recovery Act, the Dodd-Frank bill, and in the last 5 years, we have seen ourselves gain 8 million jobs, the stock market today just hit 16,501. It has gained 10,000 points since that low mark 5 years ago. So that is $13 trillion. So we put in $700 billion to save the system through TARP. That has been paid back with interest, a substantial amount. That is where we are today.

I offered—and Mr. Bentsen, you may remember this—two amendments when we went through Dodd-Frank. One was to, in effect, repeal Gramm-Leach-Bliley and reinstitute the separation of investment bankers from commercial bankers like Mr. Funk. That didn't pass. I did an amendment, too, that was—and I would offer it into the record, too, the amendment that did pass, which was two pages long.

Chairman HENSARLING. Without objection, it is so ordered.

Mr. PERLMUTTER. This amendment said, no proprietary trading. Banks, commercial banks, couldn't trade for their own account, which, Mr. Funk, my guess is your bank doesn't trade stocks or commodities for its own account.

Mr. FUNK. We do not.

Mr. PERLMUTTER. Okay. So but that then was amended in the Senate to become what is the precursor and now the Volcker Rule.

So, gentlemen, and I will start with you two, in trying as Congress dealing with the reality of the financial markets where we have major institutions that do investment banking, that do commercial banking—and it isn't just Goldman Sachs and it isn't just Morgan Stanley, but it is others. Would you have us go back to separating completely commercial banking from investment banking and insurance?

Mr. Funk, I will start with you.

Mr. FUNK. I would not, but I think you have to have restrictions in place. I am here speaking on behalf of our industry, and I think you have to have sensible regulation that monitors and that regulates.

I would also say that when you talk about regulation—I speak for the industry, and most of the bankers I know are not opposed to regulation. But it is the regulation that doesn't seem to make sense and that hurts consumers—not doesn't help consumers, but hurts consumers—is what we really have a problem with.

Mr. PERLMUTTER. And I would respond to you, when we have points of contention like the trust indenture, you have to come to us so we can correct those things. And I would offer up my services to help you or Mr. Bentsen or anybody else at the table. But we can't have the same kinds of losses that we suffered in 2008. At least not in my lifetime, I don't want to see them again.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Ohio, Mr. Stivers, for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman. I appreciate you calling this hearing.

I want to follow up on some questions and points that Mr. Duffy, the gentleman from Wisconsin, made earlier. All of you agreed that the rule would have benefited from a cost-benefit analysis. Can you raise your hand if you agree with that?

So I thought you all agreed. Did you not agree, sir?

Mr. JOHNSON. I think—

Mr. STIVERS. I said a cost-benefit analysis.

Mr. JOHNSON. I think they did an analysis of the costs and the benefits. Perhaps you have a specific other legal standard in mind. But they looked to the cost in the analysis. That is cost-benefit analysis.

Mr. STIVERS. They did not do a cost-benefit analysis as required.

Do all of you agree that the rule would be clearer if there was better regulatory coordination, or, again, does the gentleman in the middle disagree? Do most of you agree? Raise your hand if you agree.

Okay. We have one dissenter again.

On competitiveness, I have a question for Mr. Bentsen and Mr. Robertson. The Financial Times said that the Dodd-Frank rules, especially the Volcker Rule, could ultimately hamper the way that the corporate bond market now works. Do you believe the Volcker Rule will dry up liquidity in the corporate bond market? Be as brief as possible.

Mr. BENTSEN. Look, it could. As we see how these rules are put into practice and how the compliance regime works, it could cause firms to have to pull back from market-making activity that they do in the corporate bond market and other markets, and that would pull liquidity and could affect U.S. markets.

Mr. STIVERS. Mr. Robertson, do you agree with that?

Mr. ROBERTSON. I would agree as well. We have significant concerns that, depending on how it is implemented, it could reduce liquidity for underwriting and also for even warehousing debt.

Mr. STIVERS. So if there is less liquidity in the corporate bond market, will that change investors' willingness to buy corporate debt, Mr. Robertson?

Mr. ROBERTSON. Absolutely. And I think there is an issue even of just getting the inventory to market in a timely manner. And moreover, if there is not adequate access to hedges, that is also going to limit financial transactions and activity.

Mr. STIVERS. Tell me what that means to jobs in this country.

Mr. ROBERTSON. For example, at the CFTC hearing we had a CFO of an energy company which is heavily reliant on derivatives to undertake massive capital expenditures, hundreds of millions of dollars, to go out and explore for oil because they need to have that future price locked in. That is just thousands, tens of thousands, hundreds of thousands of jobs across the economy that are reliant upon risk-mitigation tools.

So depending on how this is deployed, if it has any impact on restricting access to derivatives that are used for legitimate hedging, that could have a very massive impact on the economy and jobs.

Mr. STIVERS. Thank you.

And there was previous testimony, I don't have time to get into it, that also talked about the competitiveness of America versus Europe and Asia with regard to America being the only country thus far that has banned proprietary trading, and that also would affect jobs.

My next question is for Mr. Funk. Earlier in your testimony, you said your bank is about $1 billion?

Mr. FUNK. $1.7 billion.

Mr. STIVERS. Okay, I am sorry to short you there; $1.7 billion. But your bank relies on trust-preferred securities, I assume, as part of your operations?

Mr. FUNK. They were bought in 2005–2006—

Mr. STIVERS. But they are on your books?

Mr. FUNK. Yes, $9.7 million when we bought them, a very minor part of our investment portfolio.

Mr. STIVERS. Sure. But let us say there is a bank, so in yesterday's interim final rule authorizing it, it allows banks under $15 billion to keep them.

I want to echo some remarks of Democratic Senator Sherrod Brown yesterday. Can you tell me, you are a banker, your bank has about $2 billion in assets. Does that differ from a bank that, say, has $50 billion or $60 billion in assets? Like in my community Huntington Bank is $52 billion, but they use trust-preferred securities, they are in the same exact business you are in. If those investments are not risky for you, why should they be considered risky under this requirement for somebody over $50 billion?

Mr. FUNK. I think, Congressman, the ruling yesterday applied to everyone. So I think that most banks in America are going to be very happy with what was issued yesterday. It was without regard to size.

Mr. STIVERS. So they did lift the $15 billion yesterday. Okay.

Mr. BENTSEN. I think the size issue is related to the issuer of the trust-preferred, not to the buyer of the trust-preferred.

Mr. STIVERS. Not to the buyer of the trust-preferred. So that does help. But the point is it doesn't matter your size as the buyer; it doesn't change of the risk of the investment, the size of the buyer, does it?

Mr. FUNK. I agree 100 percent with that statement.

Mr. GANZ. Congressman, that would be extremely important in the CLO context. A resolution that would cut it off based on the size of the bank holding would not work, not for the larger banks and not for the smaller banks.

Mr. STIVERS. Thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from South Carolina, Mr. Mulvaney, for 5 minutes.

Mr. MULVANEY. Thank you, Mr. Chairman.

Despite my reputation, I would like to focus for a few minutes on some things that we might be able to agree on. I recognize, in fact, my colleague Mr. Green asked if anybody wanted to completely get rid of the bill, and I think we would be kidding ourselves if we think that everybody agrees that things are perfect and we shouldn't change anything. It may be that some want to change it dramatically, and some want to change it only slightly. But let us see if we can at least figure out that some of the concerns raised here today are things that everybody can agree on might need some work in the future.

So, Professor Johnson, I am going to spend some time with you because you are the Democratic witness, and I am going to read off some of the things that Mr. Bentsen spoke about in his opening statement and just see if we can't get some agreement on what the regulators should do going forward.

You said in order to lessen the potential negative market impacts, regulators should consider as issues arise giving particular markets or products additional time to comply. Is that a fair consideration?

Mr. JOHNSON. I'm sorry, Congressman, you are speaking a little fast. Additional time to comply?

Mr. MULVANEY. I am a Southerner. Usually, I get accused of speaking slowly. Yes.

It says that as new information becomes available, regulators should consider as issues arise giving particular markets or products additional time to comply.

Mr. JOHNSON. I think given what we know now, there is sufficient time to comply. There is a long phase-in of this. If additional issues come up, like the TruPS preferred, of course they have to be dealt with. That is sensible.

Mr. MULVANEY. And it says—and, again, I don't expect noes to a lot of these. I am not trying to bait you or trick you, I am just trying to establish that there might be some things going forward, and I believe you yourself at the beginning of the testimony said that as we deal with unintended consequences, they should deserve our attention.

He also said that just as the five regulators ultimately coordinated to write one rule, they must now coordinate and be consistent in the interpretation, examination, supervision, and enforcement. That makes sense, doesn't it?

Mr. JOHNSON. I already said, Congressman, I think it is a very good idea, and I think that you should look to the FSOC and the Secretary of the Treasury to ensure that coordination takes place. That is their job under the legislation.

Mr. MULVANEY. He went on to say that it was true that we did not task any one agency or the agencies collectively with interpretation and examination. That is something we need to be focused on moving forward, correct?

Mr. JOHNSON. Absolutely. Personally, Congressman, I would prefer having a single banking regulator in the United States. Mr. Funk already has to deal with two banking regulators and the SEC. It is very—three banking regulators, my apologies, and the SEC. That is way too complicated already, but that is a century-old problem in the United States.

Mr. MULVANEY. And that goes on to another point he raises, which is what happens if the SEC gives one rule and the OCC gives another, or the FDIC gives one rule, or the Federal Reserve gives another. That is something that needs to be fixed, or at least needs to be watched as we go forward.

Mr. JOHNSON. Absolutely. That is the responsibility of the FSOC and the Secretary of the Treasury.

Mr. MULVANEY. I understand. He says it is completely unclear how the agencies plan to coordinate their efforts and avoid duplicative actions and undue costs and burdens on virtually every banking organization in the country. Another legitimate concern, correct?

Mr. JOHNSON. They certainly haven't told me how they plan to deal with it, but I would turn to the FSOC. That is their job, and I am sure they will come and testify before you at every opportunity.

Mr. MULVANEY. And finally, without beating a dead horse too much, he said that the top near-term goal should be for the agencies to articulate a transparent and consistent roadmap for coordination on both near-term interpretive guidance and long-term examination and supervisory framework. A valid concern, correct?

Mr. JOHNSON. It is a concern not just for the Volcker Rule: all of regulation and supervision should be subject to the same high standard. And I think the FDIC sets world-class standards for many or most of its activities in this regard.

Mr. MULVANEY. And very briefly, before I move on to Mr. Funk, I want to ask you one question about your testimony where you spoke to—for the line, you said over the last 20 years and since the onset of the financial crisis, the financial system has become dramatically—excuse me, "dramatically" is not in there—has become more concentrated.

I take it from the tenor and how it appears in your text that you consider that to be a bad thing or a potentially bad thing; is that correct, Professor Johnson?

Mr. JOHNSON. I'm sorry. Say the question again?

Mr. MULVANEY. This is your testimony. Over the past 20 years and since the onset of the financial crisis in 2007, the financial system has become more concentrated. I take it you perceive that as being a potential negative impact?

Mr. JOHNSON. Unfortunately, the increasing concentration has come with some very big negative consequences, including the one currently spread on the board.

Mr. MULVANEY. Is it fair to say then that if we see as an unintended consequence of the Volcker Rule even more consolidation, or, more broadly, if Dodd-Frank drives more consolidation, that is something that is potentially dangerous to the market, and we should look at that from a regulatory standpoint?

Mr. JOHNSON. I would be concerned about increased consolidation and concentration irrespective of the cause, including from any kind of legislation. Yes, Congressman.

Mr. MULVANEY. Thank you, Professor Johnson.

Finally, Mr. Funk, you said something today that I just want to clarify, because I live in a district similar to Mr. Hurt where community banks make up a large portion of our financial markets. And what you told me was, yes, you are technically not covered by this, but you really are, because in 2 years from now, you are going to have to prove that what you are doing doesn't fall under the Volcker Rule, is that correct? So in essence you are required to meet some of the same compliance regulations, even though Dodd-Frank specifically says Volcker is not supposed to apply to you?

Mr. FUNK. I think there are a lot of questions in our investment portfolio that we don't have answers for right now, and I am speaking for all banks right now. And the answer is, we don't know.

Mr. MULVANEY. And even going forward, though, if you are going to make a trade or investment, you are going to have to establish for somebody that it doesn't fall under Volcker.

Mr. FUNK. It depends if it is considered proprietary trading or not, and we don't engage in proprietary trading, nor do most banks.

Mr. MULVANEY. Thank you, sir.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Illinois, Mr. Hultgren, for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman. Thank you so much for holding this hearing and the second one to follow up. And thank you all for being here.

This is obviously a very important topic, one that I have heard so much about in the last few weeks, especially from my community banks back in my district. There is a great amount of fear, a great amount of concern, and a lot of uncertainty. It is very complex. So I have to apologize even with my questions that they are very diverse, because this rule is very diverse and very complex.

Mr. Bentsen, I wanted to address this first to you. Regarding the tender option bond market, the regulators clearly share the concern and stated in the preamble that disruption of the tender option bonds market could increase financing costs to municipalities. Does it seem possible that TOB's market may continue functioning fluidly with some adjustments to comply with the Volcker Rule? I wonder if you can talk about this process and how SIFMA and industry are thinking through this challenge.

Mr. BENTSEN. Congressman, thank you for that question. We are quite concerned with the rules—final rules treatment for tender option bonds or the lack of an exclusion for tender option bonds. They are an important tool for the municipal financing market, and we think, absent some solution, it will have a negative impact on municipal issuers ultimately.

The industry is looking at the rule and seeing if there is a way to work through it that would meet regulators' concerns. We don't have an answer yet, but it is something that is a top priority for us.

Mr. HULTGREN. Quickly, I wonder, how would you compare—Mr. Bentsen as well—these tender option bonds to municipal securities and trades involving repurchase agreements?

Mr. BENTSEN. We view them as, frankly, similar to a repurchase agreement. They are like a securities financing transaction. They provide liquidity to the muni bond market. They provide inventory financing. That passes through to the pricing of the muni bond market to the benefit of the muni issuer.

Mr. HULTGREN. Mr. Funk, I want to address this to you, if I may. First, one of my great frustrations—I talk about it often in this committee—is that under the guise of consumer protection, many new rules have come out which actually end up costing consumers. I wonder briefly, you have mentioned how people have been shifted around. Your head count has stayed the same, but you are doing probably less outreach and customer service, and more compliance.

I wonder what you think maybe the biggest impact would be for your customers from the Volcker Rule or from some of these other rules that have significant costs more than benefit.

Mr. FUNK. Just with the Volcker Rule, that is hard to say, because there is so much we don't know. I was prepared, had the TruPS issue not been answered, to talk about that. But beyond that, the effect on community banks, I think we just are waiting to find out. And there are many things that we don't know yet that probably in the next 30 to 60 days we will find out.

Mr. HULTGREN. Mr. Funk, I want to follow up on that. Many banks are not waiting until July 2015 to divest themselves of Volcker-prohibited securities. For example, BankUnited in Florida, prompted by the rule, has already sold off their CLO and re-REMIC portfolios. But in the case of re-REMICs, the status of these securities under the rules seem unclear, as many other areas are unclear as well. Am I correct in saying that there is some confusion in the marketplace regarding re-REMICS as well as some of these other areas?

Mr. FUNK. I am not an expert on re-Remics. We can certainly get back for the record, but I am not an expert on re-Remics.

Mr. HULTGREN. Anybody else have a comment quickly? Mr. Bentsen?

Mr. BENTSEN. We would be happy to get back to you for the record.

Mr. HULTGREN. Okay. Thanks. We will follow up with you.

The last question, and I would open this up, Mr. Funk, Mr. Bentsen, Mr. Robertson, and if any of you have any thoughts, on a broader note, when banks are forced to sell certain investments like TruPS, CDOs, re-REMIC securities, won't this create a buyer's market? These institutions forced to comply with the Volcker Rule will have to sell prohibited investments and potentially take a significant loss. This will be exaggerated in less liquid markets where we may see greater volatility. Isn't that true?

And I wonder, since the regulators did not perform any significant economic analysis on the final rule, are there any estimates from the bank supervisors as to what the impact of conformance may be on our community banks financially, their bottom lines, and how this will affect the market for individual securities deemed covered funds?

So in the last minute or so, I would love to hear if any of you have any thoughts on that. My thought is, if big banks, if the larger institutions are impacted, the whole market will feel the ripple effects from it. So, Mr. Bentsen, Mr. Funk, Mr. Robertson, I wonder if you have any thoughts on that?

Mr. BENTSEN. Congressman, I would just say that any time you create a fire sale situation, having to dump assets onto the market and depress the price, that is going to ripple through the whole system.

Mr. FUNK. And I think we had established it was a net of $600 million on the TruPS issue, but fortunately we have taken care of that. We haven't resolved the CLO issue or any of the other issues that we don't think are systemically risky investments that banks may be forced to mark to market and ultimately sell.

Mr. HULTGREN. The last 10 seconds, any way—again, we care about you, we want you to do well, but we really want your customers to do well. So the more you can tell us of real impact on your customers in the next weeks and months, the better.

With that, I yield back.

Chairman HENSARLING. The gentleman yields back.

The Chair now recognizes the gentlelady from Missouri, Mrs. Wagner.

Mrs. WAGNER. Thank you, Mr. Chairman, for this hearing.

Mr. Funk, as the Congresswoman from St. Louis, Missouri, I must tell you I have a great love of Midwestern banking institutions.

So I was looking at your testimony and was quite interested here, especially the section that talked about—and Mr. Hultgren spoke of it, too, a little bit—a trade-off between resources devoted to compliance management and customer engagement; of course, the reduction of resources for that kind of fine engagement, given the fact that you are spending so much money on compliance issues, and the impact that this has on growing your business, and obviously costs and access for your customers and clients.

So I have a couple of very elementary and quick questions here. Can you have a prosperous community without prosperous financial institutions?

Mr. FUNK. When I was the chairman of the Iowa Bankers Association in 2010 and 2011, and I would go around our State and I would give various talks, there was always one statement in every talk I made, and that was that we have a great State, but in every what you would call strong community, there is at least one, if not two or three, strong community banks. So I think it is almost impossible to have a strong community without strong community banks.

Mrs. WAGNER. Absolutely. And who helps create more jobs, profitable banks or unprofitable banks?

Mr. FUNK. Is that a question?

Mrs. WAGNER. Yes, sir.

Mr. FUNK. If the unprofitable banks still have capital, and they are still in operation, then they still help create jobs.

Mrs. WAGNER. Thank you for your input and answers.

Mr. Bentsen, I am sure that you are aware, sir, that SEC Commissioner Dan Gallagher is very critical of the entire process that went forward here, particularly with regard to the SEC taking what he called a back seat, frankly, to the banking regulators, who do not have expertise in securities trading. In his dissenting statement, Commissioner Gallagher at the time noted that, "this kind of interference is the product of an idealistic and ideological book club mindset unburdened by the knowledge of how complicated it is to establish and oversee regulatory programs."

Mr. Bentsen, in your opinion, was it a good idea for the banking regulators to take the lead role in drafting the Volcker Rule?

Mr. BENTSEN. That is a good question and a difficult question. I think Commissioner Gallagher is absolutely correct as it relates to the SEC's role as the market regulator. It underscores the problem really in the legislative text itself of what Volcker was trying to accomplish, and that is why in my statement I said, basically on its face it looks relatively simple, but in practice it is exceedingly complex. And that is proven out in the final rule itself. It cuts across so many different markets.

Our concern has always been that you can't have five or six or seven, if you add the National Futures Association, as Chairman Royce did. You have to have somebody in charge.

Mrs. WAGNER. Further to that, though, because I am concerned about the banking regulators taking the lead here, and one area where I think the SEC could have provided expertise is on articulating the differences between market-making and proprietary trading. Do you believe the banking regulators have, in fact, a deep understanding of the differences between these two activities?

Mr. BENTSEN. I think we hope through this process that the regulators went through to get to the final rule that the SEC's experience in market regulation came through. But I think it is going to be and should be an iterative process as we go through the implementation that we see how it is really going to work out, how the metrics are going to work, how the metrics are going to be used, how each agency is going to look at them. Hopefully, there is a uniform application of them. That is going to be important, and the SEC is going to have to play a major role.

Mrs. WAGNER. I have limited time, but I will say this: The major role of the SEC is important. And let me just ask you this: Should the SEC have, in fact, been more involved in the drafting of Volcker, do you believe?

Mr. BENTSEN. Congresswoman, I, frankly, don't know what went on behind the scenes among the regulators. We weren't invited to those meetings. But we certainly engaged with the SEC, as we did with all the regulators, as is our right and responsibility.

Mrs. WAGNER. And you talked about it a little bit, the five different mandates, five different regulators, Mr. Bentsen. In your opinion, is there any way for the regulators to apply one consistent method of enforcing Volcker when they each have a different mandate and a different approach to regulating?

Mr. BENTSEN. Oh, I certainly think that they could. I certainly think that they could get together and figure out how to come up with a uniform examination process, a uniform use of metrics, compliance and enforcement regime.

Mrs. WAGNER. I believe my time has run out, Mr. Chairman.

Chairman HENSARLING. The time of the gentlelady has expired.

Speaking of time, there appear to be two more Members to ask questions. I thank the panel again in advance for their patience and endurance.

The Chair now recognizes the gentleman from Florida, Mr. Ross.

Mr. ROSS. Thank you, Mr. Chairman.

And I will probably be pretty brief, but it is interesting, as we sit here and talk about the Volcker Rule, and I think history will reflect that probably the most significant part of the Volcker Rule in terms of its import on the markets has been the anticipation of its implementation.

Because leading up to the rule actually being released and now as we debate its implementation, we have seen, as some of my colleagues have pointed out, the divestiture of Volcker-like trading, proprietary trading. But now we are on the cusp of seeing what happens from a theoretical perspective of trying to eliminate proprietary trading to the practical application of the rule.

And, Mr. Bentsen, you have explained some of this in your opening statement and you have raised this and some of my colleagues have talked about it, in terms of when you have conflicts between any one of the regulators.

And my question, first question to Mr. Bentsen is, have the regulators given you any clarity as to how they are going to resolve conflicts and opinions as to the application of the Volcker Rule?

Mr. BENTSEN. No.

Mr. ROSS. None whatsoever.

Mr. BENTSEN. Not yet, no.

Mr. ROSS. Would that not be somewhat significant at this juncture as someone in your position as to what to anticipate?

Mr. BENTSEN. I think that really should be their next step. I think they need to—and I think trust preferreds is a good example. I think Mr. Ganz raised it about having to go see five regulators.

Mr. ROSS. And, Mr. Ganz, I appreciate your background in this, and I wonder if you could speak to the difficulty of complexities of the legal complications of having the conflicts in rulings between regulators and whether there is any recourse or due process for those who are affected by it.

Mr. GANZ. It has been very difficult to deal with the interagency issue. We have been focusing mostly on the Volcker Rule and on risk retention. And, in each case, it is either five or six agencies, and there is no real roadmap.

Mr. ROSS. And there is no due process. If a trader needs to appeal a ruling that is adverse to their position, but yet another regulator has sided with them, you are damned if you do and you are damned if you don't. Quite frankly, that is a very unusual situation to be in.

Mr. GANZ. It is not easy.

Mr. ROSS. Okay. I appreciate that.

Back to market-making, I think there is an ambiguous area where I think we are going to have probably more hard times trying to wrestle with as time goes on. Because I think you have to look at trend analysis, but it gives such a great deal of discretion to the regulators to determine whether there has been an investment based on market-making or, rather, just for self-serving proprietary trading.

In fact, Jones Day in their initial reaction to the rule stated that, "troublesome questions include the effects and consequences of a change, sudden or otherwise, in these reasonably expected near-term demands or in market cycles in times when market-making can be suspended."

Back to you, Mr. Bentsen. Have the regulators given any guidance as to what will constitute market-making?

Mr. BENTSEN. Congressman, in the final rule itself, they certainly lay out the compliance framework and systems that they expect the firms to use, including the metrics, and what they will rely upon.

What is not clear is whether they will rely upon them uniformly or across five different jurisdictions. And it is not clear how these will work. Obviously, we will have to go through that process.

Mr. ROSS. And as a litigator, I can only say that this is a wonderful thing for my profession, because it will be a relief act for those out there trying to help interpret what the application will be among several agencies.

Finally, I want to talk briefly about the investment in sovereign debt. I think when these regulations are being decided upon, there must be a consensus that there is infinite capital out there. And I think we can all agree that there is a finite amount of capital and that capital will seek the path of least resistance and the highest rate of return.

And now that we have allowed for the investment in sovereign debt, what I foresee—and, Professor Johnson, I want to get your opinion on this—is that capital will leave the domestic market and go to foreign investments, because there is no need to prove that you are innocent before guilty by way of the Volcker Rule, and instead you can invest in sovereign debt and not have to worry about investing in domestic trades.

What is your opinion about that?

Mr. JOHNSON. No, I don't think that is correct, Congressman. Obviously, investors are looking at risk, they are looking at returns, they are looking at a strong, rebounding U.S. corporate sector. There are a lot of concerns, legitimate concerns, about sovereign debt around the world. And those are the primary drivers of market attention to trends.

Mr. ROSS. I agree with you, market trends can be analyzed over time, and they can be forecast based on that. But the one element that I think happens to be hardest to manage is the impact of regulatory involvement. And I think that is what we are going to see with the Volcker Rule when I, as a banker, now have to prove that I am innocent until proven guilty. And instead of going through that compliance, instead of going through that regulatory morass of having to prove my innocence, I would rather invest my assets on behalf of those whom I have a fiduciary duty to into foreign debt. And I think that is what we are going to see happen.

And I realize my time is up, and I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Pennsylvania, Mr. Rothfus.

Mr. ROTHFUS. Thank you, Mr. Chairman.

And I thank the panel for your patience in putting up with us today. I think I am the last one.

During this hearing, someone referred to a GAO study on proprietary trading. On page 22, the GAO stated that, "staff at the financial regulators and the financial institutions we interviewed also noted that losses associated with lending and other risky activities during the recent financial crisis were greater than losses associated with standalone proprietary trading. For example, one of the firms reported increasing the reserves it maintains to cover loan losses by more than $14 billion in 2008, and another of the firms increased its loan loss reserves by almost $22 billion in 2009. Further, FDIC staff, whose organization oversees bank failures, said they were not aware of any bank failures that had resulted from standalone proprietary trading."

Mr. Funk, do you agree with the GAO that proprietary trading was not the cause of the financial crisis?

Mr. FUNK. I would say proprietary trading might be a small part of the financial crisis, but I would agree, I think it is not the sole cause by any stretch of the imagination.

Mr. ROTHFUS. And the GAO states that other activities like mortgage lending were associated with greater losses to the banks.

Wasn't the financial crisis really brought on by government-mandated policies that paved the way for the loosening of lending standards?

Mr. FUNK. That might be a part of it, but I think it is a long list that caused our financial crisis.

Mr. ROTHFUS. Mr. Robertson, as we become better educated about the Volcker Rule and the American people become better educated about the Volcker Rule, did the Volcker Rule leave in place the ability for banks to hold for their account any securities?

Mr. ROBERTSON. They can certainly hold securities as investments for sale—or, excuse me, to hold as investments. It does not allow them to have a trading portfolio in instruments.

Mr. ROTHFUS. So, educate me on a proprietary trade. Can they buy a Treasury?

Mr. ROBERTSON. They can hold a Treasury.

Mr. ROTHFUS. Could they buy a paper issued by Fannie Mae or Freddie Mac?

Mr. ROBERTSON. They could buy paper from Fannie Mae and Freddie Mac.

Mr. ROTHFUS. The same Fannie and Freddie Mac that had hundreds of billions of dollars of taxpayer—that we bailed out.

Mr. ROBERTSON. Exactly. And, to your earlier point, if you look at the anatomy of the financial crisis, it was a mortgage-driven crisis.

Mr. ROTHFUS. So we have banks that are able to hold Treasuries. Now, we have gone through this quantitative easing for a considerable amount of time. Has that suppressed interest rates, the quantitative easing?

Mr. ROBERTSON. Oh, absolutely.

Mr. ROTHFUS. And what happens when we unwind the quantitative easing? Would you expect to see interest rates go up?

Mr. ROBERTSON. Absolutely, and hopefully alongside continued economic recovery.

Mr. ROTHFUS. And when the interest rates go up, all these banks are holding the Treasuries, what happens to the principal value of Treasuries?

Mr. ROBERTSON. Obviously, if they are in extended maturity, they will decline.

Mr. ROTHFUS. Okay.

So we have established that banks are able to hold some securities—Treasuries, Fannie and Freddie paper, securities like that. Are we concentrating the types of securities, then, that banks can hold?

Mr. ROBERTSON. We are definitely putting restrictions around how they can manage those portfolios. So if we have a bank making a loan to a private middle-market company, that is a financial instrument on its balance sheet with risks. And banks take on all kinds of risk on behalf of corporate clients. To the extent that they manage those prudently, they make money, and the system is fine. To the extent that we impose constraints that are not constructive on how they manage those financial risks, we actually impair the ability for risk to be managed.

Mr. ROTHFUS. This is for Mr. Bentsen and Mr. Robertson. The regulators have backtracked on the TruPS issue with what we saw just yesterday. Does this support the conclusion that the regulators erred in not promulgating a second proposed rule or an interim final rule?

Mr. BENTSEN. We believe that they should have done a reproposal, because the initial proposal was very much like a concept release. It had 1,300 questions in it. Clearly, the regulators were struggling to figure out how to write a very complex rule off of the legislative text, and a reproposal would have been beneficial to the process. They chose not to do that, they chose not to do an interim. So we are left with the final, so we have to work with that.

Mr. FUNK. Could I add to that?

Mr. ROTHFUS. Yes.

Mr. FUNK. If I could add to that, there has been a lot of discussion today about, you had 18,000 comments, you had 3 years to make comments. We always make comments on issues we know about, and the TruPS issue was something that was completely unforeseen.

And the regulatory agencies, in our opinion, need to signal what they are going to regulate a little bit more, because this whole thing with the TruPS never would have happened had it been part of the comment period. I am confident it would have been worked out.

Mr. ROTHFUS. I thank the chairman. I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

Again, I wish to thank our witnesses for their testimony, their patience, and their endurance.

Without objection, I would like to enter into the record letters from the Independent Community Bankers of America, and the American Association of Bank Directors. Without objection, it is so ordered.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing stands adjourned.

[Whereupon, at 1:15 p.m., the hearing was adjourned.]

A P P E N D I X

January 15, 2014

Written Statement of Kenneth E. Bentsen, Jr.

on behalf of the Securities Industry and Financial Markets Association

before the House Committee on Financial Services

January 15, 2014

Chairman Hensarling, Ranking Member Waters, and members of the Committee. My name is Ken Bentsen and I am President and CEO of the Securities Industry and Financial Markets Association (SIFMA)[1]. Thank you for providing me the opportunity to testify before you today regarding our member firms' concerns about the final regulations implementing the statutory text of what has come to be known as the Volcker Rule[2]. SIFMA represents a broad range of financial services firms active in capital markets all of whom are dedicated to promoting investor opportunity, access to capital, loans to families and businesses, and an efficient market system that stimulates economic growth and job creation. America's economic success depends on a vibrant financial system that provides reliable access to capital and credit and it is with that belief in mind that I appear here today.

The concept that proprietary trading by banks and their affiliates should be prohibited and fund investments should be restricted sounds fairly straight forward. At the level where the regulation impacts real businesses and investors in the real economy, time and experience have shown that it is, in fact, exceedingly complex. Those who have grappled with the Volcker Rule at

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] In this testimony, I will refer to the final Volcker Rule to mean the combination of the final regulations and the statutory text that they implement.

any level deeper than that of a media sound bite know that balancing the statutory mandate to both prohibit and permit certain activities and investments in a way that does not harm the capital markets and the businesses, governments and investors who rely on those markets, is a very serious business and horribly complex. Indeed, Congress struggled with the complex statutory text which became the Volcker Rule and for three and a half long years, five different regulatory agencies, plus the FSOC and the Department of the Treasury have strived to find a balance of prohibitions, exemptions, restrictions and compliance regimes which will be faithful to the statutory text's mix of prohibitions and exemptions as well as the overarching policy goal not to harm the real economy. It is no wonder that the proposed rule posed over 1,300 questions and that the final rule runs 71 pages with nearly 900 pages of commentary attached to it and we are not surprised that it took the regulators a long time to complete the Rule so we are appreciative of the attention with which they approached an exceedingly difficult task.

That being said, SIFMA and our members still believe the Volcker Rule is a policy response in search of a problem and we remind the Committee that no other country has adopted anything at all similar to the Volcker Rule. It is, however, the law of the land and our members are committed to complying fully with the rule and making the required changes and putting in place conformance plans and compliance programs. The capital markets have raised more than $6.3 trillion over the past six years for U.S. companies in more than 78 different business sectors and any regulation that could so negatively affect that lifeblood of the economy will need to be monitored. Our member firms will work closely with the regulators and if necessary, the Congress, to ensure a smooth implementation with as limited an impact as possible on the broader economy.

There is no doubt that the final Volcker Rule, as it was intended, will bring about changes in our markets. The Rule represents a significant and complex change that will impact every single bank and its capital markets affiliates in the U.S. and globally, no matter its size. As the Volcker Rule comes into full force, it will affect many markets and products. The agencies have appropriately extended the conformance period to provide the financial sector and the markets time to prepare though there will undoubtedly be many unintended consequences. We caution, however, that the Volcker Rule's complexity will inevitably raise a number of interpretive issues and it is important that these be resolved thoughtfully. We will work with the regulators and legislators to ensure appropriate treatment. For example, in the short term we expect, as noted below, questions with respect to the treatment of the required metrics and we would seek to continue the dialogue as to the appropriate and consistent approach for this important requirement.

Our preliminary assessment shows that beyond the general market quality impact that will result from the significant compliance costs associated with engaging in permitted activities, the following markets/areas will be impacted: venture capital, normal corporate structures such as equity joint ventures and acquisition vehicles, municipal financing via tender option bonds, loan and other securitizations, asset-backed commercial paper, commercial loans and lending via CLOs, CDOs and the trading of foreign sovereign debt.

Regarding CLOs, we have included as appendices to this testimony two letters that SIFMA and other trade groups sent to the regulators requesting guidance related to the definition of ownership interest in the final rule as it relates to CLO transactions. We believe that guidance such as we have requested would allow holders of CLO securities to become comfortable that they did not hold ownership interests, and that their holdings were permissible under the Volcker Rule. We continue to strongly encourage the regulators to issue such guidance so as to avoid disruptions to the CLO market, and increases in the cost of credit to the Main Street businesses that benefit from the market. We note that Members of Congress have introduced legislation that would allow banks to continue to hold securities issued by CLOs if they were issued before December 10, 2013 and we support the goals of this legislation. Indeed, we believe that the relief afforded by any legislation to TruPS CDOs should also be granted to CLOs – the definition of ownership interest is a common problem and the consequences of inaction regarding CLOs are very high. That being said, we hope that guidance from the regulators would take a principles-based approach and is therefore the preferable approach.

Our members are also beginning to focus on the conformance plans and the intense compliance programs that the final regulation requires. But this work by our member firms is not the end of the story. Just as the financial sector will have to develop and implement conformance plans, compliance programs, internal controls, independent testing and auditing, training and records retention, so too will regulators have more work to do to explain what certain provisions mean and how they are intended to work. A final regulation as significant as the final Volcker Rule, with broad market impacts and a global reach, will not be simple to implement, examine or supervise. In order to lessen the potential negative market impacts, regulators should consider, as issues arise, giving particular markets or products additional time to comply. Most importantly, just as the five regulators ultimately coordinated to write one rule they must now coordinate and be consistent in their interpretation, examination, supervision and enforcement of the final regulations. A lack of consistency will not only create unnecessary and costly confusion for the industry, our clients and the markets, it will undermine the Rule itself.

The lack of an explicit mechanism or process for ongoing regulatory coordination and resolution of interpretive, examination, supervision and enforcement differences has emerged as our member firms' greatest initial concern. The law tasked five different regulators, the Commodity Futures Trading Commission, Federal Reserve Board, Federal Deposit Insurance Corporation, Comptroller of the Currency and the Securities and Exchange Commission with writing the rule, but it did not task any one agency or the agencies collectively with the interpretation, examination, supervision or enforcement of final regulations. As firms (including global firms, smaller firms and regional banking entities that are now subject to these new compliance requirements) develop these procedures, a failure to have a clear, transparent and consistent approach to address and resolve regulatory issues will only increase costs and delay achievement of the regulatory goals. Without a defined process or mechanism there is a significant risk that agencies will have differing interpretations of similar provisions or activities covered by the Volcker Rule, resulting in inconsistencies in their examination, supervision and enforcement. This will undoubtedly raise additional compliance liabilities that will cause firms to needlessly restrict activities that are otherwise explicitly allowed, the net effect of which being the restriction of capital committed to certain markets and the resultant reduction in liquidity.

Let us consider some examples. What happens if the SEC, and its examiners, takes one point of view for the broker-dealer while the OCC takes another point of view for the national bank in the same affiliated institution? Now add in the complexity of the CFTC reviewing the activities of the national bank for its registered swap dealer activities. What if the FDIC takes one view for nonmember banks and the Federal Reserve another for member banks? What if regulators in other jurisdictions impose requirements that are incompatible with the approach required by one or more U.S. regulators?

As you know, the basic building block of the trading provisions of the final regulations is **not** a legal entity or functional regulation approach of the type we have traditionally seen. Instead, the basic building block is the trading desk which the agencies have made crystal clear is meant to cross legal entities. As a result, all compliance programs and metrics reporting will also cut across legal entities and the traditional system of functional regulation. The reality is that each trading desk could be subject to examination by multiple agencies.

This concern is significant as we move deeper into firms' planning for conformance, implementation and development of compliance regimes. For example, a number of the largest financial institutions must begin tracking certain metrics of their activities by July of this year with the first reports due by the end of August. A rush to meet this deadline, particularly in light of the long delays that followed the expiration of the comment period, will have ramifications for both the regulated bodies and the regulators. Our members have concerns as to how each agency will interpret the metrics described in the Rule, as well as how and to which agency they will be reported. Differences in approach across the agencies would make metrics reporting almost impossible, especially given the fact that metrics reporting will have to be programmed into computer systems. Inconsistency in approach could also undermine the transparency and the comparability of the information from institution to institution, thus making the information far less valuable.

Regrettably, the final regulations are completely silent on regulatory coordination. The final Volcker Rule does not address how interpretations and guidance will be meted out, how examinations will be coordinated in form and result, how the agencies will work together in supervision in any respect, or how various cross-border compliance and coordination issues will be addressed. It is completely unclear how the agencies plan to coordinate their efforts and avoid duplicative actions and undue costs and burdens on virtually every banking organization in the country.

The agencies acknowledged concerns about overlapping jurisdictional authority but while they noted an intent "to coordinate their examination and enforcement proceedings to the extent possible and practicable", they provided absolutely no guidelines or procedure on how to do so.

Indeed, we understand from our members that one of the lessons learned from the entire TruPS CDO and CLO problem is that no one agency can render an interpretation and getting five different agencies to agree requires more time. We believe that the top near-term goal should be for the agencies to articulate a transparent and consistent roadmap for coordination on both near-term interpretive guidance and the long-term examination and supervisory framework, including realistic goals on quantitative reporting that prioritize utility of the data. Any delay in providing transparency around structural coordination risks creating confusion that could disrupt our capital markets and the flow of credit to our broader economy, and may very well impede our members' ability to meet already tight compliance timelines. A roadmap for coordination should seek ultimately to ensure consistency in interpretation across agencies with guidance consistently applied.

We believe it is incumbent upon the FSOC to exercise its authority to coordinate supervisory activities with respect to the Rule, as Congress provided for in the FSOC's enabling statute and in the statutory Volcker Rule itself. Additionally, we strongly believe there is an oversight role for Congress to play in ensuring such coordination and the consistent application of the Rule applies, beginning with this hearing today. Considering the lack of a re-proposal, we also urge the regulators to be flexible and open to amending the Volcker Rule through an iterative process as problems arise going forward. We note that the Volcker statute requires that the regulators "consult and coordinate with each other, as appropriate" to assure that there is "consistent application and implementation" of the Volcker Rule.

In conclusion, I wish to stress again that there remain many outstanding questions as to how the Volcker Rule will be implemented and enforced and SIFMA and its members are still carefully reading the Rule to understand its consequences. There is a strong likelihood that significant issues may arise in the coming weeks or months that are simply not on our radar screen today—the

Volcker Rule is that complex. Failure to address this could result in more compliance burdens that would undermine activities beneficial to the economy such as market making and hedging. We look forward to working with Congress, our regulators, and other market participants to ensure the implementation of the Volcker Rule is not disruptive to the capital markets and the job creators they support. With that, I look forward to answering your questions.

December 24, 2013

The Honorable Ben Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

The Honorable Thomas Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street, SW
Washington, DC 20219

The Honorable Gary Gensler
Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

The Honorable Mary Jo White
Chair
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

RE: "Ownership Interests" in Connection with Certain CLO Debt Securities

Dear Chairman Bernanke, Comptroller Curry, Chairman Gensler, Chairman Gruenberg, and Chair White:

The Loan Syndications and Trading Association ("LSTA"),[1] the Securities Industry and Financial Markets Association ("SIFMA"),[2] the Structured Finance Industry Group ("SFIG"),[3] the American Bankers Association,[4] and the Financial Services Roundtable[5] submit this letter in connection with certain aspects of the final rule implementing the Volcker Rule, adopted by your respective agencies ("Agencies") on December 10, 2013.[6] Specifically, we ask for confirmation that the term "ownership interest" as defined in §__.10(d)(6) does not include debt securities of collateralized loan obligation ("CLO") issuers that are covered funds where these CLO debt securities have a contingent right to remove a manager "for cause" or to nominate or vote on a nominated replacement upon a manager's removal for cause or resignation, but contain none of the other indicia of ownership interests listed in the definition.[7]

Section __.10(d)(6)(i)(A) of the Final Rule defines "ownership interest" to include "the right to participate in the selection or removal" of an investment manager of a covered fund, "(excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event)." We believe it is reasonable to interpret the "for cause" trigger relating to the right of the holders of CLO debt securities to remove a manager or nominate or

---

[1] The LSTA is a not-for-profit trade association that is made up of a broad and diverse membership involved in the origination, syndication, and trading of commercial loans. The 350 members of the LSTA include commercial banks, investment banks, broker-dealers, hedge funds, mutual funds, insurance companies, fund managers, and other institutional lenders, as well as service providers and vendors. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans. Since 1995, the LSTA has developed standardized practices, procedures, and documentation to enhance market efficiency, transparency, and certainty.

[2] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

[3] SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. Members of SFIG represent all sectors of the securitization market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. Further information can be found at www.sfindustry.org.

[4] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its 2 million employees. Learn more at aba.com.

[5] The Financial Services Roundtable represents 100 integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $98.4 trillion in managed assets, $1.1 trillion in revenue, and 2.4 million jobs.

[6] Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Dec. 10, 2013) ("Final Rule").

[7] For the avoidance of doubt, our request does not extend to the "equity" tranche of a CLO, even where denominated as debt, given that it does have other indicia of ownership interests.

vote on a nominated replacement upon a manager's removal for cause or resignation to constitute a "right[ ] of a creditor to exercise remedies upon the occurrence of a default" since a "for cause" removal under the management agreement is typically linked to a significant breach of the manager's obligations under the CLO transaction documents. Nevertheless, this issue has resulted in considerable confusion among our banking entity and asset manager members as they seek to understand the impact of the Final Rule on holders of CLO debt securities.

We understand that, as a result of this uncertainty, a large number of our members, which include both large and small banks, are weighing whether they will be permitted to acquire or retain any covered fund CLO debt securities that have such a controlling class feature that is a protective creditors' right. We are concerned that, unless the Agencies provide guidance that the rights described herein do not amount to an ownership interest, banking entities (including a significant number of regional and community banks) could begin to dispose of these CLO debt securities and stop acquiring new covered fund CLO debt securities, even though we believe that these rights should not be read to constitute an ownership interest. Divestment of CLO debt securities will unnecessarily disrupt the CLO market, could result in immediate and substantial capital losses for banking entities, and will ultimately impair the availability of, and increase the cost of, corporate lending since banking entities play a significant role in providing continued liquidity to the CLO debt market and CLOs provide significant capital and liquidity to the corporate loan market.[8] The impact of these losses will not only be felt by banking entities but also by non-bank investors that hold CLO debt securities, as these securities will experience a loss in market value driven by the forced selling.

CLOs provide the holders of their debt securities with a number of creditor rights designed to protect their debt interests. Most of these rights are vested in the "controlling class," typically the most senior class of debt securities then outstanding. However, since CLO debt securities are paid serially, any class of these debt securities can become the controlling class after the prior classes have been paid in full. An important creditor's right is to remove the CLO manager for cause. Events constituting cause for removal may involve, for example, a willful breach by the manager of its obligations under the CLO transaction documents, the dissolution or insolvency of the manager, or fraud or criminal activity by the manager in connection with its investment management business. These types of events pose clear and direct threats to the interests of holders of debt securities as creditors of a CLO, and their ability to respond to and remediate these threats is properly viewed as an essential creditor's right, and not as an ownership interest.

In addition, the resignation of the manager is tantamount to a change of control of the issuer — a circumstance under which traditional bank lenders often receive consent rights or the right to be repaid. Investors thus view the ability to vote on a replacement manager, too, as an important creditors' right.

---

[8] *See* Forbes, "Volcker Rule's Non-Exemption of CLOs with Bonds Holds Potential to Disrupt Markets," Dec. 17, 2013, available at http://www.forbes.com/sites/spleverage/2013/12/17/volcker-rules-non-exemption-of-clos-with-bonds-holds-potential-to-disrupt-market/.

In almost all CLOs, some percentage of the controlling class of holders of debt securities (sometimes with holders of other classes of debt securities as well) have the contingent right to remove the manager for cause.[9] In the event of a removal for cause or a manager's resignation, typically the controlling class of debt securities and the equity holders each have the right to propose to the other a successor manager. If the parties are unable to agree on a replacement, they, or even the CLO issuer or the resigning manager, may ask a court to appoint a successor.

While for cause removal and replacement upon resignation or removal rights are common creditor protective rights in CLOs, they are not typically structured to occur in the context of an event of default or an acceleration event under the CLO securities indenture, even though they are only triggered upon a manager's default under the CLO management agreement or its resignation. As such, there is some uncertainty as to whether CLO debt security holders that have these rights would or would not be deemed to have an "ownership interest" under the Final Rule.

If a CLO debt security with these contingent creditor protective rights is treated as an "ownership interest," a banking entity would be prohibited from, or severely limited in, acquiring or continuing to hold debt securities in any CLO that is a covered fund, even though none of the attributes of such debt securities has the characteristics of an equity or other typical ownership interest. Holders of CLO debt securities only have the right to specified principal and interest. They do not have the right or ability, directly or indirectly, to share in the CLO's profits or losses or to earn a return based on the CLO's performance. They also do not have the types of voting rights that typically attach to equity securities, like the right to vote on establishing an entity's objectives and policies or electing its board of directors. The contingent right to participate in the replacement of a manager in the remote event of a removal for cause or resignation is far narrower than rights that accompany equity-like interests and do not provide holders of CLO debt securities with the ability to control the decisions of the manager.[10]

Moreover, as a practical matter, it is very difficult to restructure an existing CLO or to obtain consent to amend CLO documentation to modify the rights of holders of debt securities. The Agencies recently indicated in a different context that banking entities could consider whether an investment structure could be restructured, for example to avail itself of an exemption under the Investment Company Act other than Sections 3(c)(1) or 3(c)(7), thereby taking it out of the scope of the covered fund definition.[11] However, each Investment Company Act exemption contains conditions that would be unworkable for existing CLOs. For example, if a CLO were to be restructured to rely on Investment Company Act Rule 3a-7, the manager could

[9] CLO equity holders may also have this right. Unlike the holders of CLO debt securities, however, and as noted above, the CLO equity holders satisfy most if not all of the indicia of "ownership interest" under the Final Rule, and we are not seeking clarification as to their interests in this letter.

[10] We understand that, to the extent that a CLO debt security in fact meets any of the indicia of "ownership interest" in the Final Rule (other than the limited right to participate in the selection or removal of a manager discussed above), such security would constitute an "ownership interest" and be subject to all applicable covered fund restrictions.

[11] We refer to the FAQ issued by the federal banking agencies on December 19, 2013, titled, "FAQ Regarding Collateralized Debt Obligations Backed by Trust Preferred Securities under the Volcker Rule."

be significantly limited in its ability to sell assets, even outside of the reinvestment period. Neither managers nor equity holders of actively managed CLOs would likely agree to such restrictions. There may also be significant logistical difficulties in amending outstanding CLOs (especially in the case of CLO debt securities held through a clearing organization whose holders are not known to the CLO issuer), and the amendment of a large number of outstanding transactions would require significant expense. Furthermore, even when all affected debt security holders are known, certain security holders that are not banking entities may be unwilling to give up what are considered to be important creditors' rights.[12]

We thus request confirmation from the Agencies in an interpretive letter, FAQ, or other appropriate form that the term "ownership interest" as defined in §__.10(d)(6) does not include debt securities of CLO issuers that are covered funds, where these CLO debt securities give holders a contingent right to remove a manager "for cause" or to nominate or vote on a nominated replacement upon a manager's resignation or removal, but contain none of the other indicia of ownership interests listed in the definition.

Please feel free to contact Elliot Ganz, LSTA's General Counsel, at (212) 880-3003 if you have any questions regarding this letter.

Sincerely,

R. Bram Smith
Executive Director
Loan Syndications and Trading Association

Christopher Killian
Managing Director
Securities Industry and Financial Markets Association

Richard Johns
Executive Director
Structured Finance Industry Group

[12] As of the date of this letter, the aggregate amount of U.S. CLOs outstanding is $303 billion, of which $153 billion were issued before September 2008.

Cecelia A. Calaby
Executive Director and General Counsel
American Bankers Association

Richard Foster
Senior Counsel for Regulatory &
Legal Affairs
Financial Services Roundtable

LSTA
THE LOAN SYNDICATIONS AND TRADING ASSOCIATION®

sifma
Invested in America

SFIG
Structured Finance Industry Group

FINANCIAL SERVICES ROUNDTABLE

January 10, 2013

The Honorable Ben Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

The Honorable Thomas Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street, SW
Washington, DC 20219

The Honorable Mary Jo White
Chair
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

RE: "Ownership Interests" in Connection with Certain CLO Debt Securities

Dear Chairman Bernanke, Comptroller Curry, Chairman Gruenberg, and Chair White:

The Loan Syndications and Trading Association ("LSTA") and the Securities Industry and Financial Markets Association ("SIFMA") are grateful to the staffs of the Federal Reserve Board ("Federal Reserve"), Federal Deposit Insurance Corporation ("FDIC"), Office of the Comptroller of the Currency ("OCC"), and Securities and Exchange Commission ("SEC") for taking the time to meet with us on Thursday.[1] We submit this letter on behalf of the undersigned organizations as a follow-up to the meetings and to our letters of December 24, 2013 and December 31, 2013 (the "December Letters"),[2] to clarify certain aspects of those letters and the discussions in the January 9 Meetings, and to propose language that would confirm, in a FAQ or other appropriate interpretive guidance, that the term "ownership interest" as defined in §__.10(d)(6) of the final rule implementing the Volcker Rule[3] does not include debt securities of collateralized loan obligation ("CLO") issuers that are covered funds, as described below, solely because they have the creditor-protective rights described below, whether or not an event of default or acceleration event exists under the CLO indenture.

Section __.10(d)(6)(i)(A) of the Final Rule defines "ownership interest" to include "the right to participate in the selection or removal" of an investment manager of a covered fund, "(excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event)."

As discussed in the December Letters, CLOs provide the holders of their debt securities with a number of creditor rights designed to protect their debt interests. Most of these rights are vested in the "controlling class," typically the most senior class of debt securities then outstanding.[4]

We have confirmed that most existing controlling class CLO debt security holders have the contingent right to participate in the removal and replacement of the CLO manager, but only for cause pursuant to the transaction documents. The definition of "cause" that would trigger the right of removal includes, for example, a willful breach by the manager of its obligations under the CLO transaction documents, the dissolution or insolvency of the manager, a material failure of a representation or warranty that is not timely cured, or fraud or criminal activity by the manager in connection with its investment management business.

Most existing controlling class CLO debt security holders also have the right to participate in the replacement of a manager after the manager's resignation. The resignation of the manager is tantamount to a change of control of the issuer — a circumstance under which traditional bank lenders often receive consent rights or the right to be repaid.

In the event of a removal of the manager for cause by the debt security or equity holders,[5] or the manager's resignation, typically the equity holders and/or the controlling class of debt security holders each have the right to propose to the other a successor manager. If the parties

[1] Representatives of the LSTA and SIFMA met with Federal Reserve, FDIC, and OCC staff on the morning of January 9, 2014, and with SEC staff that afternoon (the "January 9 Meetings").
[2] The undersigned organizations are the LSTA, SIFMA, the Structured Finance Industry Group ("SFIG"), and the Financial Services Roundtable ("FSR"). The December Letters, including the description of each of our organizations, are incorporated herein by reference.
[3] Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Dec. 10, 2013) ("Final Rule").
[4] Since CLO debt securities are paid serially, any class of these debt securities can become the controlling class after the more senior classes have been paid in full.
[5] The equity holders also typically have the right to remove the manager for cause.

are unable to agree on a replacement, they, or even the CLO issuer or the resigning manager, may ask a court to appoint a successor.

As discussed in the December Letters and the January 9 Meetings, these "for cause" and resignation events pose clear and direct threats to the interests of holders of debt securities as creditors of a CLO, and their ability to respond to and remediate these threats is properly viewed as an essential creditor's right, and not as an ownership interest.

Importantly, CLO debt securities typically do not have any of the other indicia of ownership interest described in subsections (6)(i)(B) through (G) of Section __.10(d) of the Final Rule.[6]

We thus request confirmation from the Agencies in a FAQ or other appropriate interpretive guidance that the term "ownership interest" as defined in §__.10(d)(6) does not include debt securities of CLO issuers that are covered funds, where these CLO debt securities give holders only a contingent right to remove a manager "for cause" or to nominate or vote on or consent to a nominated replacement upon a manager's removal for cause or resignation, but contain none of the other indicia of ownership interests listed in the definition.

We believe that adoption by the Agencies of either proposed Alternative 1 or 2 below would allay the concerns of banking entities as to whether their debt securities represent ownership interests solely because of the removal and replacement rights described herein. These proposals are substantively identical but we have offered alternative constructions for your consideration.

Based on our meeting with the Federal Reserve, FDIC, and OCC, we are also offering a third alternative, which would require that the CLO collateral consist predominantly of loans. We continue to believe, however, that the creditor-protective rights described herein, standing alone (*i.e.,* without any of the other indicia of "ownership interest" in the Final Rule), should not qualify as an "other similar interest" regardless of the makeup of the covered fund. Indeed, the contingent right to remove a manager for cause generally needs action by a majority (or super majority) of a controlling class of CLO debt security holders.

Proposed language

Alternative 1:

> The Agencies confirm that the rights of a holder of debt securities of a CLO that is a covered fund to participate in the removal of a manager solely "for cause," as defined in the CLO transaction documents (CLO management agreement, indenture or other related

[6] While the full impact of the final rule is still being assessed, we understand that banking entities believe that, if necessary, they likely will be able to obtain an opinion of counsel that the ownership interest indicia set forth in subsections (6)(i)(B)-(F) and subsection (6)(i)(G), except as it relates to subsection (6)(i)(A), will not apply to most CLO debt securities. However, they almost certainly will not be able to obtain a similar opinion of counsel in connection with subsection (6)(i)(A). Our request does not extend to any CLO debt security that would meet any of the indicia of ownership interest other than in subsection (6)(i)(A).

> documents governing the issuance and management of the CLO), and to nominate or vote on or consent to a nominated replacement manager upon a manager's removal for cause or resignation, constitute "rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event" under section __.10(d)(6)(1)(A) of the Final Rule, whether or not an event of default or acceleration event exists under the CLO indenture, as long as the debt security does not meet any of the other indicia of "other similar interest" set forth in subsections (6)(i)(A) through (F) or subsection (6)(i)(G), except as it relates to subsection 6(i)(A) in the limited manner set forth above.

Alternative 2:

> The Agencies confirm that the clause: "rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event" under section __.10(d)(6)(1)(A) of the Final Rule includes, whether or not an event of default or acceleration event exists under the CLO indenture, rights of a holder of debt securities of a CLO that is a covered fund to participate in the removal of a manager solely "for cause," as defined in the CLO transaction documents (CLO management agreement, indenture or other related documents governing the issuance and management of the CLO), and to nominate or vote on or consent to a nominated replacement manager upon a manager's removal for cause or resignation, as long as the debt security does not meet any of the other indicia of "other similar interest" set forth in subsections (6)(i)(A) through (F) or subsection (6)(i)(G), except as it relates to subsection 6(i)(A) in the limited manner set forth above.

Alternative 3:

> The Agencies confirm that the clause: "rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event" under section __.10(d)(6)(1)(A) of the Final Rule includes, whether or not an event of default or acceleration event exists under the CLO indenture, rights of a holder of debt securities of a CLO that is a covered fund to participate in the removal of a manager solely "for cause," as defined in the CLO transaction documents (CLO management agreement, indenture or other related documents governing the issuance and management of the CLO), and to nominate or vote on or consent to a nominated replacement manager upon a manager's removal for cause or resignation, as long as:
>
> > (i) the debt security does not meet any of the other indicia of "other similar interest" set forth in subsections (6)(i)(A) through (F) or subsection (6)(i)(G), except as it relates to subsection 6(i)(A) in the limited manner set forth above; and
> >
> > (ii) the CLO must be comprised predominantly of loans.

Once again, we are grateful for the staffs' time and consideration of this important issue. As we discussed in the January 9 Meetings, there is significant urgency to our request. Not only does the uncertainty as to treatment of CLO debt securities raise a number of complex and time-sensitive accounting issues, but, absent a timely resolution, we are concerned about a substantial market disruption.

Please feel free to contact Elliot Ganz, LSTA's General Counsel, at (212) 880-3003 if you have any questions regarding this letter.

Sincerely,

R. Bram Smith
Executive Director
Loan Syndication and Trading Association [LSTA]

Christopher Killian
Managing Director
Securities Industry and Financial Markets Association [SIFMA]

Richard Johns
Executive Director
Structured Finance Industry Group [SFIG]

Richard Foster
Senior Counsel for Regulatory &
Legal Affairs
Financial Services Roundtable [FSR]

cc: The Honorable Mark Wetjen
Acting Chairman
Commodity Futures Trading Commission

Federal Reserve
Christopher Paridon, Legal Division
Anna Harrington, Legal Division

FDIC
Karl Reitz, Capital Markets Strategies
Michael Phillips, Counsel
Michael Spencer, Senior Policy Analyst
Robert Storch, Chief Accountant

OCC
Jamey Basham, Legal Division
Stephanie Boccio, Credit and Market Risk Group

SEC
Lona Nallengara, Chief of Staff
Amy Starr, Division of Corporation Finance
Katherine Hsu, Division of Corporation Finance
David Beaning, Division of Corporation Finance
Diane Blizzard, Division of Investment Management

Cecelia A. Calaby
American Bankers Association

January 15, 2014

Testimony of

Charles Funk

On behalf of the

American Bankers Association

for the hearing

"The Impact of the Volcker Rule on Job Creators"

before the

Committee on Financial Services

United States House of Representatives

American Bankers Association

Charles Funk

On behalf of the

American Bankers Association

before the

Committee on Financial Services

of the

United States House of Representatives

January 15, 2014

Chairman Hensarling and Ranking Member Waters, my name is Charles Funk, President and Chief Executive Officer of the MidWest One Financial Group. My bank is a $1.7 billion community bank headquartered in Iowa City, Iowa. We serve 19 communities with a total of 25 offices and have been in business since 1934. In several communities, there are only one or two banking offices in the community. I appreciate the opportunity to be here to represent the American Bankers Association (ABA) regarding the recently finalized Volcker Rule and some of the unintended consequences it is already creating. The ABA represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees

Let me begin by thanking you, Mr. Chairman, Ranking Member Waters, and Subcommittee Chairman Capito and many other members of this Committee for your recent engagement with the regulators on the important issue related to the unnecessary and potential significant losses on collateralized debt obligations secured primarily by trust preferred securities. I would also like to thank Chairman Hensarling and Chairman Capito for introducing H.R. 3819—which ABA strongly supports—to provide relief to banks like mine that would suffer considerable losses on these assets under the rule finalized by the regulatory agencies.

For my bank, the immediate write down on our investment in collateralized debt obligations (CDOs) secured primarily by trust preferred securities (TruPS) issued by banks would be a loss of $1,050,000 and could be much larger since the entire market for TruPS CDOs will be in turmoil and values could decline if this problem is not addressed. For many smaller institutions the losses anticipated are devastating, resulting in a hit to capital that will inhibit them from lending to their community. Across the holders of these securities the losses are expected to be at least $600 million and likely to be much higher as this rule could create a sellers-only market.

The sad part is that we and most other banks intended to hold these investments until they mature (up to 30 years) and would likely see the values improve from today's low levels. But instead, by government fiat we will take losses now that would not only hurt our earnings, but more significantly hurt our ability to serve our community. Moreover, these investments would never be considered a concern that the Volcker Rule was intended to prevent.

Let me be clear at the outset. Like the Dodd-Frank Act, the Volcker Rule is the law of the land. While the banking industry has concerns with aspects of the rule, our focus now is to ensure that it be applied in a way consistent with its original intention to address systemic risk, not impose costs on banks like mine unrelated to systemic issues. We are very concerned that the agencies' rule is so broad that it has consequences far beyond what Congress intended and will hurt legitimate investments that not only are safe and sound choices for banks, but that support the credit availability and financial service needs of our customers.

It is remarkable that what began as an 11 page amendment in Dodd-Frank, designed to limit excessively-risky proprietary trading at the largest systemically important institutions, has transformed into a 936 page final rule that will have a real, measurable impact on banks of ***all*** sizes. By taking an overly broad approach, the regulations to implement the Volcker Rule impose serious unintended consequences that will fundamentally change the business of banking with little or no benefit to the stability of the financial system.

There is real irony in the fact that a rule designed to prevent banks from taking losses on short-term assets will instead force banks to sell long-term investments early, often resulting in a market loss. By forcing large numbers of banks to sell assets at discount prices, the government is picking winners and losers and inflicting pain without cause. The less regulated non-bank sector—which was complicit in the problems that led to the financial crisis—will have an opportunity to buy assets with recovering values at discount prices at the expense of the banks.

Simply put, the Volcker Rule should not impair traditional banking services that allow banks to meet the needs of their customers, nor impose unnecessary costs on any bank, particularly regional and community banks, where no argument of systemic risk can be justified.

In my testimony today I would like to make the following three points:

- The agencies' Volcker Rule has serious unintended consequences for banks of all sizes;
- Legislation—such as H.R. 3819— is important to address the imminent negative consequences faced by banks holding Trust Preferred Pooled Securities
- The agencies' Volcker Rule is likely to create unintended consequences beyond Trust Preferred Pooled Securities and Congress should be vigilant in assuring that rules are focused on the original intent to reduce systemic risk and not used to hinder the traditional business of banking: providing credit to customers.

I will discuss each of these in turn and offer some suggestions for ways that Congress can add clarity to achieve consistent implementation of the Volcker rule, beyond dealing with the emergency situation surrounding Trust Preferred Pooled Securities.

I. The Volcker Rule Has Serious Unintended Consequences for Banks of All Sizes

The purpose of the Volcker provision in Dodd-Frank was relatively simple—to prevent large systemically important banks from engaging in excessively-risky proprietary trading activities that put systemic financial stability at risk. The finalized agencies' Volcker Rule, however, took an overly broad approach to this issue resulting in serious consequences for banks of all sizes. Many of the activities covered by the final rule pose no risk to the financial system, and are engaged in by community, mid-size and regional banks. The rule will force many of these banks to write down or sell assets that they had never planned to sell at a significant loss and cease to provide lending options that they have safely offered to their customers for years.

At the time these affected investments were made, they were sound and legal choices, and in some cases (like issuing Trust Preferred Securities to boost the capital and lending capacity of small banks) encouraged by regulators. Now, by government fiat, the rules of the game have changed and these are now being artificially flagged as questionable investments.

I have seen this impact at my own bank. In 2005, we purchased $9.7 million in collateralized debt obligations (CDOs) secured primarily by trust preferred securities issued by banks. This was a well thought out and robustly discussed long-term investment. We only invested in floating rate trust preferred pooled securities that were rated A or better. It made sense for us at the time, as we were vulnerable to rising interest rates and had few floating rate loan opportunities.

These securities plummeted in market value as the financial crisis of 2008-09 worsened because of the financial stress of some community banks that had issued trust preferred securities that were packaged in these instruments. At year-end 2008, we had recorded an impairment loss and wrote the securities down to approximately $1.8 million. Even though this significantly diminished the bank's operating earnings for the year, we did not hesitate to take the charge, recognizing that the resulting balance reflects the ultimate amount we expect to collect. Although the security's market value at the time was far lower than $1.8 million book value, accounting rules required us to write down the investment only to the net realizable value because we are able to hold the investment to the recovery of that value.

Since then, we have evaluated the securities on a quarterly basis and have determined that no additional impairment has been necessary. Each quarter, we analyze the future cash flows for each debt obligation.

While the market value for these securities remains significantly below our recorded investment, what we have found for the past 18 months or so is that the securities' estimated future cash flows have hit bottom and have begun to improve. ***Most importantly, if we continue to hold these securities well into the future (10-15 years), we expect to eventually recover our current book value and could well recover more than current book on certain securities.*** Holding these securities was exactly what we planned to do, and with tangible common equity in our company of more than 9.5%, we have the staying power to hold these investments indefinitely.

The recent decision to disallow these securities as permissible investments comes as a surprise to our entire management team and Board of Directors and is contrary to the original intent of the Volcker Rule to prevent future risky behavior. During the comment period on the proposed Volcker Rule implementing regulations, we did not receive any signal that these investments would be disallowed. In fact, we thought they would be excluded from the rule.

While we acknowledge that the investment has performed below our initial expectations, the agencies' Volcker Rule arbitrarily and unnecessarily makes this much worse—at least a further ***immediate*** market-value write down of $1,050,000 and maybe more—with no hope to recover the value of our investment. This investment was a casualty of the economic crisis of 2008-09, but never can it be considered an adventurous investment or one that presented a systemic risk, and it certainly never should have been captured by the Volcker Rule.

To be forced to sell these investments by 2015 will come at a great cost, not just because it hurts our earnings, but because it necessarily strips away resources that would be channeled back into our community. For many smaller banks, the impact is even more severe than for my bank. ABA has heard from many banks about the problems they anticipate. For example:

- A community bank of just over $100 million in assets, with fewer than 30 employees, and serving five counties in rural Mississippi (with few other banks in their markets) purchased about $3 million of Federal Reserve designated "bank qualified" CDOs secured by trust preferred securities. If forced to sell, this community bank would take an immediate capital hit and would be forced to stop any new business lending.

- An Oklahoma bank with $300 million in assets expects to take $1.4 million in market-value losses if forced to divest their TruPS CDO portfolio today. If allowed to hold these securities to their maturity however, they expected to see a gain on their investment. For a bank with $300 million in assets that type of loss will significantly impact the services they provide to their community.

- A Connecticut based Mutual Bank with $1.4 billion in assets and 15 branches expects that immediate market-value write-downs on its portfolio of CDOs secured by trust preferred securities, resulting from the agencies' Volcker Rule, would cause their Tier 1 capital ratio to fall 100 basis points. Being a mutual institution, this bank has no access to outside capital, and can only increase capital through retained earnings, a challenge given the current economic environment.

- A $1.4 billion bank in Oklahoma, holding $13 million in CDOs secured by trust preferred securities expects it would take an immediate market-value loss of $4 million (4% of holding company capital) if required to sell its portfolio. Although this bank expects to remain well capitalized the OCC has placed additional capital requirements on the bank following its acquisition of a failed bank from the FDIC. As a result of this market-value loss, they will barely be able to meet these additional capital requirements. This will have a significant impact on how they are able to manage the bank and the loans they are able to make to local businesses that they have served for many years.

- A $100 million dollar bank, serving Marshal County Mississippi – one of the poorest counties in the state—currently holds $2.8 million in of CDOs secured by trust preferred securities. They expect that under the agencies' Volcker Rule they would need to write down $2.4 million in market value, which would reduce their bank's capital in excess of 20%, severely limiting their ability to serve their community.

- A $400 million bank in Louisiana holds about $8 million of CDOs secured by trust preferred securities, which they expect to sell for 15 cents on the dollar if required by the agencies' Volcker Rule. This cost would be a 200 basis point hit to their capital level, and erase their record earnings year with the stroke of a pen. While sales may not be required for 18 months, the market value loss must be taken now, leaving no incentive to hold the security any longer.

The important point is that all these losses are completely avoidable if the banks were allowed to hold these investments to maturity. It is only because these investments are captured under the agencies' final Volcker Rule that these losses have to be realized. These investments in no way resemble a trading asset, yet would have to be classified as such by a rule that forces their divestiture; a rule, by the way, intended by Congress to prevent losses to banks from ***trading*** activities. As the market values for these securities still do not reflect the actual value of holding these investments, the write-downs (which are caused solely by the requirement to dispose) are also unnecessarily punitive.

In many cases, implementing this rule hits community banks, which are often the only source of banking for rural communities and have very limited access to outside capital. This means a real impact for a community that depends on them for lending and other financial services to support community growth. For our bank, our management team has been very clear with our employees and board that as our company improves its profitability, we will increase our charitable giving to worthy organizations in the communities we serve. This has met with resounding praise both inside and outside the walls of our bank. ***There is no question that a charge to earnings of more than $1 million will mean less giving to such worthy causes as the United Way, local Food Banks and capital projects for our area schools that require private funding to complete.***

I have only addressed here the immediate and quantifiable unforeseen consequences relating to holdings of CDOs secured by trust preferred securities that are unnecessarily captured by the agencies' implementation of the Volcker rule. The ABA is already hearing from banks of all sizes that these and many other sound and legal investments in pooled assets are being forced to be sold, which will forego income they would have received and may create losses that could affect their capital position.

II. Legislation—Such As H.R. 3819— Is Important to Address the Imminent Negative Unintended Consequences Faced By Banks Holding Trust Preferred Pooled Securities

We applaud the leadership of this committee for introducing legislation that would provide relief from the sudden and unnecessary write downs of Trust Preferred Securities resulting from the agencies' Volcker Rule implementing regulations. ABA strongly supports H.R. 3819. Because of the timing of this rule, my bank and many other banks must—both unexpectedly and unnecessarily—record market value losses on Trust Preferred Securities for our year-end financial statements. Even though we previously intended to hold these securities to maturity, thus eliminating the need to recognize temporary pricing changes, accounting rules require full mark-to-market loss recognition upon the expectation of selling, which would be required under the agencies' Volcker Rule. Because we must file our financial statements within just a few weeks, there is considerable urgency to have relief and to enact these bills.

We understand there has been some discussion about imposing limitation on relief based on the size of the bank that holds CDOs secured by Trust Preferred Securities (TruPS CDO) investments. ABA believes that there should be no size limitation for relief for bank investments in TruPS. As I have mentioned above, issuing Trust Preferred Securities (TruPS) enabled community banks to raise long-term funds that the regulators allowed to count as capital. Most community banks have limited access to outside capital, so TruPS issuance was an important vehicle for them. Importantly, those banks could only issue TruPS if there were a market for them of willing buyers. This market demanded a pooling of TruPS issued by several banks (into CDOs) for diversification, and relies not just on other small banks as investors—although many stepped up to buy these and help fellow community banks. Rather, the market by necessity needed to be bigger, with banks of all sizes participating. There is no reason to hurt any investor, regardless of size, that had endeavored to help community banks raise capital and serve their communities. It's unfair to punish them now.

Moreover, any asset size cutoff for holders of investments is arbitrary and picks winners and losers. Investments in TruPS CDOs were reasonable investments (at the time they were made) and due to the impairment already suffered, most banks expected to hold these for a long period of time to recover what value they could. It makes no sense for these long-term investments (that have been regaining lost value) to suffer losses regardless of the size of the holder.

Perhaps even more importantly, if banks above $15 billion were required to write down or sell their TruPS CDO investments together and in a relatively short period of time, the entire market suffers a devaluation. If the market is hurt by write downs, it affects ***all*** investors—including smaller community banks.

Besides a devaluation of the entire market, a write down or sell off by the larger institutions could create problems for the issuing banks as it may imply that the pool of bank issuers in any TruPS CDO are weak or troubled. Artificially low prices on existing securities would also make it appreciably more expensive for the issuer to raise additional capital. Why create another potential problem for community banks by forcing a write down by larger bank investors?

As I have mentioned above, TruPS CDOs are ***not*** an investment that raises any concerns related to the kinds of proprietary trading restrictions envisioned under the Volcker Rule. Because community banks can no longer issue TruPS to count as capital, the market will disappear as these securities mature. There can be no systemic issue related to these securities, regardless of the size of the holder. Moreover, the mid-size and regional banks that hold these securities are not systemically important and their investments would not rise to the level to be considered a problem for the financial system. Holdings of TruPS CDOs of large banks are miniscule compared to their balance sheet and pose no systemic issue at all.

III. The Unintended Consequences of the Agencies' Volcker Rule Go Beyond Trust Preferred Securities

The Volcker Rule was designed to promote financial stability by prohibiting banks from future engagement in excessively-risky proprietary trading. Most community, mid-size and regional banks are not and have never been involved in this kind of activity. Although the statutory prohibition on investment in funds focuses on hedge funds and private equity funds—as was the intent behind the Volcker Rule—the final rule opted for an extremely broad definition of "Covered Funds." The definition is so broad because it refers to two exemptions from the Investment Company Act (ICA) of 1940 that are intended to permit pools of securities or other assets to be offered to either a very small number of investors (less than 100), or only to any number of wealthy, sophisticated investors. These two exemptions are used by all kinds of pooled funds that are not hedge funds and private equity funds and that, for banks and the economy as a whole, serve many useful lending and economic development purposes.

As a result of this broad definition, many investments—made by banks of all sizes—in collateralized debt obligations (CDOs), collateralized mortgage obligations (CMOs), collateralized loan obligations (CLOs), and venture capital investments will no longer be allowed. As discussed above, TruPS CDOs are instruments that inappropriately fall under the broad implementing regulation. But the implementing rule also exacerbates the overbroad definition of "covered funds" by unexpectedly making it impermissible for banks to hold debt instruments issued by loan pools. Pooling loans to permit banks to diversify their exposure to borrowers is an important risk-mitigating tool for banks, especially for smaller institutions where one borrower can represent a significant portion of a bank's assets. The ability to invest in debt instruments issued by pools of loans spreads any individual risk across a greater amount of capital, and is not the kind of equity trading investment that the Volcker Rule was intended to capture.

The fact that the Volcker Rule created an exemption for any CLOs and CMOs that hold ***exclusively*** loans shows recognition of the importance of these natural extensions of the business of banking. ***However, very few CLOs or CMOs are currently constructed this way.*** This means that banks must evaluate the composition of every CLO and CMO held, and must sell any that do not meet the agencies' punitively strict Volcker standards. As is the case with TruPS, creating a market where sellers outnumber buyers will drive prices sharply lower. Furthermore, in the future a tiered securitization structure is likely to emerge, with both "bank eligible" and "non bank eligible" debt. Banks will surely have to pay a premium for the increased scrutiny on bank eligible CLOs and CMOs.

Although the Volcker Rule provides a time period over which banks can divest any assets that do not comply with the rule, the delay of actually selling will not help save the banks from incurring losses on these investments. The agencies' Volcker Rule allows banks until July 21, 2015 to divest themselves of noncompliant assets. The goal of this was to ensure that all of the assets did not hit markets all at once, limiting losses. However, both the accounting standards and the markets are smarter than that, with the accounting requiring ***immediate losses*** to be recorded (thus reducing capital) and the markets factoring the increased supply and reduced demand into the pricing (thus resulting in market losses upon actual sale).

Simply put, by forcing banks to sell performing assets by 2015, the agencies' Volcker Rule is creating distortions in markets with more sellers than buyers. This depresses prices below what they would be in a fair market, where willing and rational buyers and sellers determine the market prices. As a result of the agencies' actions, the less regulated non-bank investors will be the true winners from the Volcker rule as they pick up performing assets at discount prices at the banks' expense.

I would also note that even if relief can be provided for TruPS, there will remain a significant compliance burden under the rule for community banks, despite agency statements to the contrary. Since a single investment in a covered fund could potentially trigger enforcement actions against the bank, its officers or directors, community banks will put in place compliance monitoring procedures to ensure they do not inadvertently violate the Volcker Rule. This means that every bank, regardless of size must evaluate every investment it holds and determine whether it is covered by the Volcker Rule. This is by no means a straightforward process due to the overbroad definitions used by the final rule for "Covered Funds" and the uncertainty created in the final rule regarding debt interests. Banks must evaluate every single investment they have made in any kind of pooled asset, including the usual and ordinary investments they make in loan pools.

Banks must evaluate every collateralized debt obligation (CDO), collateralized mortgage obligation (CMO), and collateralized loan obligation (CLO). These are assets commonly held by banks of all sizes, that are rarely, if ever traded.

There is another subtle, yet substantive, negative aspect to the events of the past four weeks. At my bank, we spend a considerable amount time and money evaluating and planning to implement regulatory changes. To the extent we devote more resources to compliance management, such as implementing the Volcker Rule, there will most certainly be reduced resources available to serve our customers and help them grow their businesses and plan for their future. For every bank in America, there is always a trade-off between resources devoted to compliance management and customer engagement.

The ABA believes that more can be done beyond the emergency situation related to Trust Preferred Securities to provide clarity in the law to help regulators achieve consistent rules that focus on the original intent of the Volcker Rule without unintentionally sweeping in ordinary, useful, and safe banking activity. We believe that the lack of clarity in the statutory language in some important respects has made it difficult to achieve consistent implementation of the Volcker rule. Legislation to correct these deficiencies could include:

- Focus the prohibition on investment in covered funds to investments in hedge funds and private equity funds (as the statute now reads) without reference to exceptions from the Investment Company Act of 1940;

- Clarify the process for interpretation of implementing regulations as well as requiring agreement and coordination of any enforcement action.

These enhancements to the statute should prevent unintentional impact, including the harmful impact we are seeing on banks holding TruPS CDOs. Further, as the agencies move forward to implement and supervise compliance with the Volcker rule, clarity of interpretive authority will prevent contradictory and duplicative application of the rule. The agencies maintain the broad range of supervisory judgment and actions already available to them.

Conclusion

Despite assertions to the contrary, Dodd-Frank has imposed many new compliance burdens on community institutions. The Volcker rule is just the most immediate concern for community banks. The mission of the Volcker rule was relatively simple—to prevent large systemically important banks from engaging in risky proprietary trading activities that put systemic financial stability at risk. As it is now written, it is an incredibly complex rulemaking that will create tremendous compliance burden for banks of all sizes. Despite the intent to focus this rule on only the largest, systemically important institutions, there will be real tangible compliance costs for community and regional banks that pose no threat to systemic financial stability. All banks, regardless of size will need to fully understand this complex rulemaking and its implications on their operations. Furthermore, many of these will need to implement costly compliance programs, despite the fact that they have never engaged in anything resembling proprietary trading.

The ABA believes that the Volcker Rule should not impair traditional banking services that allow banks to meet the needs of their customers, nor impose costs on banks, particularly regional, mid-size and community banks, where no argument of systemic risk can be justified.

The ABA appreciates and fully supports the bill introduced by the leaders of this important Committee. There is need for urgent action so that banks can avoid write downs they have no reason to make. By taking action now, banks will be better able to serve their communities. We urge this Committee to continue its vigilance in assuring that the agencies' rulemaking does not create unintended consequences that inevitably will lead to fewer resources that can be devoted to all the communities across this nation that banks serve.

THE LOAN SYNDICATIONS AND TRADING ASSOCIATION

Testimony of Elliot Ganz

Executive Vice President and General Counsel of the Loan Syndications and Trading Association

House Committee on Financial Services Hearing on

The Impact of the Volcker Rule on Job Creators

January 15, 2014

Good morning, Chairman Hensarling, Ranking Member Waters and members of the Committee. My name is Elliot Ganz, and I am the Executive Vice President and General Counsel of the Loan Syndications and Trading Association, or LSTA. The LSTA is an association that represents the interests of all participants in the $3 trillion corporate loan market.[1] We thank you for the opportunity to testify regarding ***The Impact of the Volcker Rule on Job Creators***.

This hearing is very timely given the recent issuance of the final rules implementing the Volcker Rule[2]. The impact of this and other parts the Dodd-Frank Act will be felt not only by the financial sector, but also by American businesses and job creators that require affordable and efficient financing. Dodd-Frank, and the Volcker Rule in particular, will result in significant unintended consequences, some of which are already starting to hit home. Our member firms have been working with the agencies for more than three years in an effort to mitigate these consequences and will continue to do so going forward.

My testimony will focus on how the Volcker Rule's definition of "ownership interest" could negatively impact credit availability for American companies. The Final Rule would profoundly disrupt the market for open market Collateralized Loan Obligations, or CLOs. This disruption could lead to a significant reduction in the amount of credit available to the some of the most dynamic, job creating companies of America, and would result in material and arbitrary losses to American banks that hold almost $70 billion of safe, highly-performing CLO securities.

What Are CLOs?

Perhaps the best place to start is by describing what a CLO actually is. CLOs are straight-forward, "long-only" investment funds that invest in the ingenuity, creativity and health of

---

[1] The LSTA, founded in 1995, is the trade association for the syndicated corporate loan market and is dedicated to advancing the interests of the market as a whole. The LSTA engages in a wide variety of activities intended to foster the development of policies and market practices designed to promote a liquid and transparent marketplace. More information about the LSTA is available at www.lsta.org.

[2] Final Rule, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (Dec. 10, 2013) ("Final Rule").

366 Madison Avenue, 15th Floor, New York, NY 10017
Tel: 212.880.3000 Fax. 212.880.3040 www.lsta.org.

American companies. They support growth and most importantly, American jobs. CLOs are not complicated derivatives where some people bet for and some people bet against the very same securities in the portfolio. Nor are they "originate-to-distribute" structures that create loans for the sole purpose of selling and securitizing them.

At bottom, CLOs are securitization funds managed by independent investment advisers registered with the Securities and Exchange Commission that issue securities to different types of institutional investors in order to purchase senior, secured corporate loans. **More than 90% of the proceeds of those funds are invested in senior, secured commercial and industrial loans made to American Companies.** As of today, CLOs hold approximately $300 Billion of these loans. This represents almost half of all loans made by non-banks in the United States. These loans are made to some of the most dynamic companies in America, across all states in industries including cable, broadband, satellite, cellular telephony, health and hospitals, energy, airlines and retail. Often, these growing, job-creating companies have no other access to the capital markets other than through the loan market.

Companies that access the CLO market include such American staples as Sears (which employs 275,000 people), Aramark (250,000), SuperValue Stores (130,000), JC Penney (116,000), Community Health (96,000), Dollar General (90,000), Rite Aid (90,000), Goodyear Tire (69,000), Delta Airlines (74,000), and American Airlines (65,000). Scores of smaller companies also rely on CLO financing, including, Regal Cinemas (22,000), Armstrong World Industries (8,500), ABC Supply (7,500) and Quikrete (3,500). In all, we estimate that companies that access the CLO market for financing employ more than 5 million people.[3]

As an investment, CLOs have performed remarkably well over the years, including during the financial crisis. **Since 1996, the cumulative impairment to CLO debt securities has been less than 1.5%. There have been practically no realized losses on these securities during or after the financial crisis.** There are six primary reasons for the strong performance of CLOs mostly relating to the many protections built in to the CLO structure for the benefit of investors:

(i) **Underlying Assets**. CLOs typically hold at least 90% of their assets in senior, secured commercial and industrial loans. These loans have performed very well over the last three default cycles beginning in the late 1980s (and including the recent financial crisis), experiencing a modest annual default rate and an average recovery-given-default rate of about 80 cents on the dollar. As described above, these are real loans to real American companies. CLOs invest in portions of 100-150 individual loans to companies like these, and these loans trade in a transparent secondary market.,

(ii) **Diversification**. CLO portfolios are highly diversified and, unlike real estate securitizations, are not reliant on any particular industry. In fact, CLOs are

[3] While the companies speak for themselves, it may still be worth noting that the companies that have accessed CLO financing deliver vital products and services throughout the country. For instance much of the infrastructure for rural cellular phone coverage was financed through CLOs.

usually limited to investing no more than 3% of their portfolios in the loans of any single borrower and no more than 15% in any single industry sector.

(iii) **Alignment of Interest**. The majority of a CLO manager's compensation is paid only after the note holders are paid. The manager does not get paid most of its fees unless the CLO portfolio performs as expected.

(iv) **Regulatory Oversight**. Virtually all CLO managers are registered under the Investment Advisers Act which entails a range of fiduciary obligations that protect investors and subjects CLO managers to supervision by the SEC. All purchases and sales of the CLO's assets must be conducted on an arm's-length basis in compliance with the Investment Advisers Act.

(v) **Structural Protections**. CLOs have overcollateralization restrictions and interest coverage tests that protect senior note holders. If, for some reason, the CLO does not perform well, instead of the equity and the manager being paid, funds are used to pay off the senior notes

(vi) **Transparency and Disclosure.** CLO investors receive monthly reports that include a list of CLO assets - and for each asset - its interest rate, maturity date, and the type of asset. Investors receive a report on the aggregate principal balance of the portfolio and a breakdown of how much each asset comprises of the portfolio. They also receive a summary of the overcollateralization test and interest coverage test. Finally, they receive a report on all purchases, repayments, and sales during that period as well as the identity of any defaulted loans. CLO investors have a substantial amount of relevant information available to them.

How Have CLO Debt Securities Performed?

Not surprisingly, CLO debt securities have performed very well historically. In 2013, U.S. debt securities rated A, AA and AAA returned an average of 3.9% to investors[4]. During that same time period all other fixed income securities lost 2.5%[5]. Moreover, cumulative impairments (not losses) on CLO debt securities since 1996 are less than 1.5%. Practically no CLO debt investor has lost any money through and after the recent financial crisis.

Why Do Banks Invest in CLO Notes?

Attracted by the safety and soundness of CLOs, their historical performance and their excellent risk-adjusted returns, a wide range of U.S. banks currently invest almost $70 billion in these

[4] Bank of America Merrill Lynch CLO Weekly, January 10, 2014, available at http://rcr.ml.com/Archive/11347776.pdf?w=eganz%40lsta.org&q=aOVjPABRxo-5YpytkUrEsw&__gda__=1389538989_00d84a51fd7f108ce232833a74d5f17f.

[5] Merrill Lynch US Broad Market Index.

securities.[6] While a significant amount of CLO debt securities are held by large banks, CLO debt securities are also held by 21 U.S. banks with assets of less than $25 billion, including a number of community banks.[7]

How Does the Final Rule Disrupt the CLO Market?

The Final Rule arbitrarily and artificially "converts" highly rated CLO debt securities into the equivalent of equity securities thereby making them ineligible to be held by banks[8]. As a result, over the 18 months banks will have to divest, or attempt to orchestrate the restructuring of up to $70 billion of CLO Notes.

The Final Rule contains seven "indicia of ownership" that are intended to insure that debt securities that have certain equity-like features are treated under the Volcker Rule as ownership interests rather than debt. Any of these indicia, standing alone, is enough to constitute an ownership interest under the Final Rule. The last six of these provisions properly relate more to the economic control of the entity and the potential for securities holders to receive an "upside" if the fund performs well. These six provisions are generally not applicable to CLOs, but if they were, we would agree that they would be indicative of an ownership interest rather than debt. The first provision,[9] however, includes **"the right to participate in the selection or removal" of an investment manager of a covered fund, "(excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event)."** Unlike the first six, this provision protects creditors from unexpected circumstances *and is not related in any way to the economics of the transaction.*

CLOs provide the holders of their debt securities with a number of creditor rights designed to protect their debt interests. Most of these rights are vested in the "controlling class," typically the most senior class of debt securities then outstanding.[10] Most existing controlling class CLO debt security holders have the contingent right to participate in the removal and replacement of the CLO manager, but only "for cause," as such term is defined in the transaction documents. The definition of "cause" that would trigger the right of removal includes, for example:

- a willful breach by the manager of its obligations under the CLO transaction documents;

[6] Based on a review of Call Reports as of September 30, 2013.
[7] Id.
[8] Banks invest almost exclusively in the AAA and AA rated notes of CLOs. These notes typically yield a fixed annual return above LIBOR, usually in the range of LIBOR + 1.15-1.45% for AAA rated notes and approximately LIBOR + 2% for AA rated notes. In contrast, CLO equity tranches yield more than 10% per annum. The difference in the yields reflects the fact that equity holders, the true owners of the CLO, are taking the most risk and therefore reaping the most reward. In contrast, the AAA and AA notes are simply a debt investment. If the banks "owned" the CLO – as the Volcker Rule indicates they do – they would earn far more on their investment.
[9] Section __.10(d)(6)(i)(A) of the Final Rule defines "ownership interest" to include "the right to participate in the selection or removal" of an investment manager of a covered fund, "(excluding the rights of a creditor to exercise remedies upon the occurrence of an event of default or an acceleration event)."
[10] Since CLO debt securities are paid serially, any class of these debt securities can become the controlling class after the more senior classes have been paid in full.

- the dissolution or insolvency of the manager;
- a material failure of a representation or warranty that is not timely cured; or
- fraud or criminal activity by the manager in connection with its investment management business.[11]

Most existing controlling class CLO debt security holders also have the right to participate in the replacement of a manager after the manager's resignation. The resignation of the manager is tantamount to a change of control of the issuer — a circumstance under which traditional bank lenders often receive consent rights or the right to be repaid.

These "for cause" and resignation events pose clear and direct threats to the interests of holders of debt securities as creditors of a CLO, and their ability to respond to and remediate these threats is properly viewed as an essential creditor's right, and not as an ownership interest.[12] *Oddly, the Final Rule carves out from the definition of ownership interest a security whose rights to remove or replace a manager stem from the occurrence of an event of default but do not carve out such rights when they are* ***triggered by provisions that are meant to prevent an event of default****.*

In the absence of interpretive guidance from the agencies or action from Congress, this provision threatens to seriously disrupt the CLO market. The provision arbitrarily converts CLO debt securities into the equivalent of equity securities even though they have none of the indicia of ownership that markets expect from equity securities. Since banks are prohibited from holding ownership interests in "covered funds"[13], including CLOs that hold any securities, that artificial conversion of debt securities into ownership interests makes CLO debt securities prohibited for banks to hold.

What Will Happen if the Final Rule is Not Clarified?

While the date on which banks must fully conform with the Final Rule is still months away, existing accounting standards make the implications of the Final Rule troublesome almost immediately. Institutions holding CLO debt securities where the current market value is lower than the security's cost will be forced to recognize that difference as a loss because they can no

[11] *See, e.g.,* Offering Circular for "Finn Square CLO LTD", available at http://www.centralbank.ie/regulation/securities-markets/prospectus/Lists/ProspectusDocuments/Attachments/14788/Prospectus%20-%20Standalone%20302052.PDF. Transaction contains, at pp. 128-130, typical "for cause" manager removal and replacement provisions.

[12] It is worth noting that holders of CLO debt securities affirmatively choose to invest in a particular CLO specifically because of the track record and reputation of the CLO manager. The last thing they want or expect to do is remove and replace the very manager they have chosen. It is only in extremely rare and unexpected circumstances that one would expect to invoke these rights.

[13] Covered funds are defined in a way that includes securitization vehicles, such as CLOs, that rely on the 3c-1 or 3c-7 exemptions to the Investment Company Act of 1940.

longer represent that such CLO debt securities can be held until the market price recovers (since the Final Rule requires their divestment). These losses will reduce bank capital levels unnecessarily and arbitrarily. Indeed, even the risk of being in a situation where such losses would need to be recognized will immediately reduce the attractiveness of these securities. If banks are unwilling to participate in CLOs, this will immediately increase the cost of capital for those borrowers that typically rely on CLOs. These risks will put downward pressure on prices for CLO debt securities, thereby triggering further selling pressures, leading to a cascade of falling prices triggering further sales *despite no fundamental changes in the projected cash flows of the underlying CLO debt security*. To put this in perspective, while banks holding CDOs of TruPs may have to recognize, on an accounting basis, cumulative losses (that have already occurred) of up to $600 million, if the price of CLO debt securities were to drop by only 10%, banks holding CLO debt securities would face potential cumulative losses of up to $7 billion, **which losses would be driven solely by imposition of the Final Rule.** The Final Rule as written would cause banks to recognize significant losses on otherwise safe, high quality assets, which furthers no regulatory objective.

Can the Debt Securities be Restructured to Comply with the Volcker Rule?

For a number of reasons, it is not realistic to expect that $70 billion of CLO debt securities can be restructured to comply with the Final Rule over the next few months. First, in order to amend these securities, majorities of *all* classes of securities holders, not just the holders of the senior debt securities, must consent and the interests of these classes are not always aligned. In addition, because many of these securities are held at depositaries in nominee name, it may not even be possible to identify all the holders of the other securities.

Some banks have considered simply waiving their rights, but there is no consensus in the legal community that a bank could effectively waive its rights to exercise its removal and replacement rights unilaterally. Finally, while managers could theoretically agree to sell their securities and not purchase new securities (thus making the CLO exempt from the Volcker Rule as a non-covered fund), this, too, is unlikely on a large scale because managers (who are not impacted by the Final Rule) have fiduciary duties to all its securities holders and would be unwilling to sell securities at a loss. The bottom line: Banks, especially the smaller ones, will be under immense pressure to divest quickly.

Because the prospects for restructuring are so remote, every bank that holds CLO debt securities faces a prisoner's dilemma; i.e., when to run for the exit. The smaller banks that have fewer resources and less market power are especially vulnerable. Regardless of when they sell, they will be facing a buyer's market, and will have to sell sound, performing assets at a loss. This will result in a hit to their capital, solely due to regulatory overreach. This, in turn, means that these banks will have less money to lend into their local economies in the case of community banks, or to small and medium sized job-creating businesses in the case of mid-size banks. At the same time, the disruptive effect of this selling on the overall CLO market will make it more difficult for U.S. companies that rely on this market to borrow at affordable rates.

How Can the Agencies Fix This Problem?

The LSTA has requested confirmation from the Agencies in a FAQ or other appropriate interpretive guidance that the term "ownership interest" as defined in §__.10(d)(6) of the Final Rule does not include debt securities of CLO issuers that are covered funds, where these CLO debt securities give holders only a contingent right to remove a manager "for cause" or to nominate or vote on or consent to a nominated replacement upon a manager's removal for cause or resignation, but contain none of the other indicia of ownership interests listed in the definition. We believe that adoption by the Agencies of this proposal would allay the concerns of banking entities as to whether their debt securities represent ownership interests solely because of the removal and replacement rights described herein.

We note that some members of the Senate have introduced legislation[14] that would allow banks to continue to hold debt securities issued by CLOs that were issued before December 10, 2013. We support this legislation and are grateful to the members who support it. The grandfathering of existing CLO loans would mitigate the Volcker Rule's disruptive effect on the corporate loan market, and would permit both banks and CLOs to continue to finance economic expansion and job growth. Nevertheless, we understand that the legislative process is always fraught with uncertainty. It is our hope that the regulators will take their cue from Congress and issue the regulatory guidance described above.

Conclusion

As enacted, the Volcker Rule was intended to prohibit banks from owning hedge funds, private equity funds and the like. This is a point on which the law's proponents and detractors agree. Nothing in the law's legislative history indicates an intention to prohibit banks from owning CLO debt – the debt of funds that invest, almost exclusively, in corporate loans. Nevertheless, that is what the Final Rule will do. Not only is the result inconsistent with the law, but it will significantly deplete bank capital, reduce CLO liquidity, and drive up the cost of financing for American job creators. In the absence of a countervailing policy goal, this cannot be the result that Congress envisioned, or one that it should embrace. Should the Final Rule be implemented as is, it will likely increase the cost of financing for American businesses and force companies to curtail expansion plans, forego new hiring and cut dividends - all of which are avoidable and will hurt ordinary Americans who are still recovering from financial crisis.

---

[14] S.1907, 113th Cong. (2014) (introduced by Senator Kirk (R. Ill.) and cosponsored by Senators Crapo (R. Id.), Toomey (R. Pa.), Barrasso (R. Wy.), Enzi (R. Wy.), Moran (R. Ks.) and Wicker (R. Mi.) on January 9, 2014).

Testimony submitted to the House Financial Services Committee, Hearing on "The Impact of the Volcker Rule on Job Creators, Part I," at 10am on Wednesday, January 15, 2014. Embargoed until the hearing starts.

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of http://BaselineScenario.com.[1]

A. Main Points

1) Sound principles lie behind the "Volcker Rule" (Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act; P.L. 111-203).[2] Very large banks in the United States are perceived as "too big to fail", because their potential distress and failure would likely cause massive damage to the rest of the financial system. As a result, the downside risks created by these institutions are borne, in part, by the government and the Federal Reserve – as a way to protect the rest of the economy.
2) Financial crises have a major persistent and negative impact on job creators and the rest of the real (i.e., non-financial) economy. Research conducted at the Federal Reserve Bank of Dallas suggests that the 2007-09 crisis cost at least one year's GDP, in terms of foregone output and related impact.[3]
3) Allowing today's very large bank holding companies to engage in proprietary trading and highly speculative investments (including in private equity and hedge funds) amounts to allowing them to take large bets subsidized by the tax payer.[4] Some bets may be profitable – and even encourage bigger bets – but over the credit cycle this kind of behavior is a major source of systemic financial risk.[5]
4) Allowing such subsidized risk-taking by the largest bank holding companies also confers a big unfair advantage on them relative to smaller community banks and other financial firms.

---

[1] Also a member of the private sector Systemic Risk Council (founded and chaired by Sheila Bair), a member of the Congressional Budget Office's Panel of Economic Advisers, and a member of the F.D.I.C.'s Systemic Resolution Advisory Committee. All views expressed here are personal. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide daily updates and detailed policy assessments for the global economy. For additional affiliations and disclosures, please see this page: http://BaselineScenario.com/about/.

[2] See http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf. The final regulatory rules announced in December are here: http://www.sec.gov/rules/final/2013/bhca-1.pdf.

[3] Tyler Atkinson, David Luttrell, and Harvey Rosenblum, "How Bad Was It? The Costs and Consequences of the 2007-09 Financial Crisis," Dallas Fed Staff Papers, No. 20, July 2013.

[4] The recent U.S. Government Accountability Office Report "Government Support for Bank Holding Companies: Statutory Changes to Limit Future Support Are Not Yet Fully Implemented" (GAO-14-18) provides useful detail on the wide range and enormous scope of support provided by the official sector to large bank holding companies during the financial crisis of 2007-10.

[5] In the last cycle, losses on proprietary bets were an important problem at firms such as Citigroup, Morgan Stanley, and Merrill Lynch, as well as at Bear Stearns, Lehman Brothers, Wachovia and Washington Mutual. Not all such bets are put on by designated proprietary trading desks, and some of the bets may have been unintentional. The Volcker Rule is intended to limit all such behavior.

5) The Volcker Rule by itself does not end all the problems associated with "too big to fail" financial firms. However, it is a helpful way to reduce the risks to taxpayers and to the broader economy, as well as to level the playing field within the financial sector.
6) The Rule has been designed to allow market-making and a range of permitted activities, including direct hedging of positions – while limiting excessive betting, including the so-called "macro hedging" that was sometimes used to mask proprietary trading. The regulators received a great deal of industry comment on the details, and there was a long process of listening to concerns from practitioners.
7) As a result, the negative impact of the announced Rule has been minimal. Representatives of large banks predicted dire consequences if the Rule were to be adopted, including on sovereign bond spreads in Europe, overall fixed-income market liquidity, and even potentially on credit conditions in the U.S.. Financial markets are typically forward looking, so the expected future effects of any such rule are likely to be felt in advance of full implementation, yet none of these negative consequences has actually transpired.
8) The Rule published in December imposes an additional cost on community banks, by forcing them to divest themselves of TruPS (trust preferred securities) CDOs (collateralized debt obligations) over time and, by implication, to mark these securities to market immediately.[6] Fortunately, there are signs that the regulators will quickly adjust the rule to remove this requirement for community banks.[7]
9) The best way to fix this problem would be to grandfather issuers with less than $15 billion in total assets from this provision of the Volcker Rule. A broader exemption would risk creating a back door for very large bank holding companies to take proprietary bets. Morgan Stanley made CDO-related bets in 2007 and JP Morgan lost a great deal on such bets in 2012.[8]
10) Discouraging banks from investing in TruPS CDOs in the future makes sense, but this is already being handled within the existing regulatory framework. Any exemption should cover securities issued in the past (e.g., through December 2013), rather than securities to be issued in 2014 or beyond. But the intent of the Collins Amendment (Section 171 of the Dodd-Frank Act) was clearly to exempt community banks from being impacted by the Volcker Rule.[9]
11) To prevent future such issues, it would be wise and appropriate to have a community banker on the Board of Governors of the Federal Reserve System. This is a long-standing tradition and Elizabeth Duke ably played this role through summer 2013. However, no one in the latest slate of proposed governors has much or any experience with community banking.

---

[6] Banks were allowed to issue trust preferred securities in 1996. The interest paid was deductible but banks were allowed to treat them as capital for regulatory purposes. TruPS are subordinated to other forms of bank debt, and the issuer is typically allowed to miss some payments. See http://online.wsj.com/news/articles/SB10001424052970204770404577080803185437584.

[7] Reportedly, several hundred community banks would be affected by the Rule published in December.

[8] These collateralized debt obligations have not done well – to understand why, see the analysis of Nick Dunbar (http://www.nickdunbar.net/articles/volckers-cdo-smackdown/ and his book, The Devil's Derivatives).

[9] According to analysis from SNL Financial (http://www.snl.com/InteractiveX/Article.aspx?cdid=A-26308730-12083), Zions BanCorp, with total assets of over $55 billion, faces an unrealized loss of around 12 percent of Tier 1 common capital on structured trust preferred holdings. The other banks with large holdings of or losses on TruPS-related instruments, relative to their balance sheets, are all under $15 billion in total assets, so should be covered by the Collins Amendment.

B. Assessment of the Volcker Rule

The announcement in December 2013 of the Volcker Rule, restricting proprietary trading and limiting other permissible investments for very large banks, is a major step forward. Almost exactly four years after the general idea was first proposed by Paul A. Volcker, the former chairman of the Federal Reserve, and nearly three and a half years since it became law, the regulators have finally managed to produce a rule.

This rule could be meaningful, and this is why there has already been so much pushback from the big banks. Their main strategy so far – denial that there is a problem to be addressed – has failed completely. Their legal challenges are also unlikely to succeed. The main issue now is whether the regulators force enough additional transparency so that it is possible to see the new ways that proprietary bets are hidden.

The Volcker Rule is intended to impact only the very largest banks – the material impact will be mostly on JPMorgan Chase, Bank of America, Citigroup, Goldman Sachs and Morgan Stanley. The goal is simple and sensible. Given that these banks are supported by large implicit government backstops (e.g., from the Federal Reserve), they should be more careful in their activities and should not engage in large-scale bets that have the potential to cause insolvency for them and disruption for the rest of the global financial system.

These companies could choose to become smaller, with the constituent pieces operating under fewer restrictions. But their managements want to stay big, so they should face additional constraints.

The first pushback strategy – and the main focus of big bank efforts to date – is to deny that the Volcker Rule is needed at all. This line has been pushed hard over the last four years, including at a Senate hearing in February 2010.

Barry Zubrow, then chief risk officer at JPMorgan Chase, testified that the Volcker Rule was not needed, as risk controls in big banks were sufficient to the task. (I also testified at the hearing, in favor of the rule.) The extent to which JPMorgan Chase subsequently managed its own risks – including proprietary trading-type activities run out of its chief investment office – has been called into question. Mr. Zubrow retired at the end of 2012, telling his colleagues, "We have learned from the mistakes of our recent trading losses."

I hope that is true, but it seems unlikely, because the name of the game for very large banks is leverage, i.e., taking big bets using a lot of borrowed money and very little equity.[10] This is how to boost your return on equity, unadjusted for risk, which is what financial analysts (and the

[10] On this point, see Anat Admati and Martin Hellwig, The Bankers' New Clothes: What's Wrong with Banking and What to Do about It, Princeton University Press, 2013. A close reading of this book suggests that the recently proposed supplemental leverage ratio is a step in the right direction – but only a small step that is likely to prove insufficient. The increase in capital requirements under Basel III is also unlikely to make much difference – one senior official recently described this as moving maximum permissible leverage (debt relative to total assets) from 98-99 percent pre-2008 to around 97 percent for the future.

related news coverage) focus on. Most regulators now have this point much more clearly in their minds.

At the same time, Mr. Zubrow and others asserted that the introduction of any kind of Volcker Rule would have a big negative effect on financial markets and the economy. But as the adoption of the rule has approached, financial markets have taken that news completely in stride. Yes, we have lower employment levels than we would like, but that's primarily due to the large financial crisis since the Great Depression, brought on by excessive risk-taking (for example, at Citigroup).

The conceptual fight against the Volcker Rule has been lost by the big banks, at least in part because of the London Whale losses overseen by Mr. Zubrow and his colleagues – but also because enough regulators have finally wised up to how the big banks really operate and why that can damage the real economy.

The second strategy is to find new ways to hide the essence of proprietary trading – and this is an important open issue. Will there be enough disclosure and observable behavior for either the regulators or people on the outside to see whether the spirit of the Volcker Rule is being followed? For example, how exactly will traders be compensated and how much of this will be disclosed? Will data be available on trading activities, allowing independent researchers to look for patterns that might otherwise elude officials?

The Volcker Rule could be a major contribution to financial stability. Or it could still flop. The devil now is in the details of implementation and compliance – and how much of this becomes public information and why what time lag.

C. The Scale of Implicit Subsidies Benefiting Large, Complex Financial Institutions

Being "too big to fail" means that today's very large bank holding companies benefit from unfair, nontransparent and dangerous government subsidies that encourage reckless gambling. When things go well, the benefits of these arrangements are garnered by the executives who run these firms, as they are paid largely on the basis of return on equity, unadjusted for risk. When things go badly, the downside costs are pushed in various ways onto the taxpayers and all citizens, including through higher, persistent levels of unemployment, much higher budget deficits, and elevated levels of public sector debt.

These potential costs are huge. For example, the increase in federal government debt (held by the private sector) as a direct result of the financial crisis is estimated by the Congressional Budget Office as likely to end up over 40 percent of GDP.[11] In addition, the financial crisis

[11] To measure just the fiscal impact of the finance-induced recession, compare changes in the CBO's baseline projections over time. In January 2008, the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to $5.1 trillion by 2018 (23% of GDP). As of January 2010, the CBO projected that over the next eight years, debt would rise to $13.7 trillion (over 65% of GDP)—a difference of $8.6 trillion. Of the change in CBO baseline, 57% is due to decreased tax revenues resulting from the financial crisis and recession; 17% is due to increases in

destroyed more than 8 million jobs and seriously disrupted the lives of ordinary Americans in many other ways.

Megabanks with a great deal of debt and little equity (i.e., dangerously low capital levels) are prone to financial distress and major collapses.[12] These structures create a nontransparent contingent liability for the federal budget in the United States. They also damage the nonfinancial business sector both directly – e.g., when there is a credit crunch, followed by a deep recession – and indirectly through creating a future tax liability.

The funding advantage of megabanks relative to other financial institutions creates an incentive to become even larger and even more global – thus making them even harder to control and more dangerous in an economic downturn (as seen now in Europe's euro area).

These subsidies are also extremely unfair to smaller financial institutions, including community banks. Over the past 20 years, and since the onset of financial crisis in 2007, the financial system has become more concentrated.

One major mechanism through which banks gamble is through various forms of "proprietary trading," although this risk-taking is not always accurately described as such when banks report on their activities.

The legislative intent of the Volcker Rule is to clamp down on these activities, forcing the largest banks to become safer.

Not surprisingly, there is a great deal of pushback from these banks, arguing that the Volcker Rule will create costs for the broader economy. These concerns are exaggerated and the evidence in support of the banks' main propositions is tenuous at best. Such defenses of existing banking practices also neglect the costs imposed on the broader economy due to the financial crisis – and hence the benefits we can gain from limiting the ability of executives at big banks to destroy their companies and thus damage the economy.

D. Other Concerns Raised by Very Large Banks

Over the past four years, large bank holding companies and their representatives have warned of dire consequences if the Volcker Rule were to be implemented. To date, there is no sign of these outcomes.

---

discretionary spending, some of it the stimulus package necessitated by the financial crisis (and because the "automatic stabilizers" in the United States are relatively weak); and another 14% is due to increased interest payments on the debt – because we now have more debt.

[12] There is nothing in the Basel III accord on capital requirements that should be considered encouraging. Independent analysts have established beyond a reasonable doubt that substantially increasing the required equity funding for large banks (i.e., their capital) would be advantageous from a social point of view (e.g., see the work of Anat Admati of Stanford University and her colleagues, including Anat Admati and Martin Hellwig's book, The Bankers' New Clothes). But this is not going to happen, particularly if we rely on international coordination, as with the latest discussions on the supplemental leverage ratio.

First, bankers express concern that the Volcker Rule would discriminate against "safe" foreign sovereign debt. But if a bank is holding sovereign debt as a classic long-term banking investment, then this is in the "banking book" and hence not prohibited under the Rule. Similarly, if a bank is underwriting or market-making for sovereign debt, then this is also a permitted activity. The only restriction in question is whether a US banking entity can purely "prop trade" sovereign debt, i.e., buying and selling (or engaging in derivative transactions) for the purpose of short-term capital gain.

Proprietary trading in foreign sovereign debt is inherently risky. This is exactly the kind of gambling that led to the recent demise of MF Global. Just because someone claims that the debt of a foreign government is "safe" does not mean that is true. In fact, financial history is full of examples in which investment bankers (including those based in the U.S.) miscalculate or make exaggerated claims regarding sovereign risks. This point is only reaffirmed by recent experience in Western Europe, for example for Greece and Italy.

U.S. government debt is treated differently under the Rule – and this is appropriate. Trading in U.S. government securities was principally included as a permitted activity because treasuries are the major instrument used by banks as collateral for a range of transactions and for asset-liability management. No further statutory extension or definition of permitted activity for Treasuries is needed – and the same holds for municipal debt. Underwriting and market-making are already permitted, and classic "banking book" holdings are also permitted for U.S. government debt.

Concerns that the Volcker Rule would have a negative or inappropriate impact on sovereign spreads, in Europe or elsewhere, appear to be misplaced. As is usual, those spreads are determined by a combination of fiscal credibility and what financial markets expect the relevant central bank to do in the sovereign bond market.

Second, there is concern that the Volcker Rule would hurt liquidity and capital markets. The arguments were sometimes vague, but a more specific version was contained in a report by the consulting firm Oliver Wyman, "The Volcker Rule: Implications for the US corporate bond market," commissioned by the Securities Industry and Financial Markets Association (SIFMA), an organization that represents some of the largest bank holding companies.[13]

The Volcker Rule is designed to remove subsidies from large banks that also operate proprietary trading at any significant scale. We should expect executives from these firms to oppose removal of these subsidies. To the extent that such subsidies may be expected to benefit shareholders, it can be argued that these executives also have a fiduciary responsibility to do all they to ensure the subsidies continue (i.e., that the effectiveness of the Volcker Rule be undermined).

[13] http://www.sifma.org/issues/item.aspx?id=8589936887. The report is available on the SIFMA webpage that contains its comment letters to regulators. On p. 36 of the report, the disclaimer begins, "This report sets forth the information required by the terms of Oliver Wyman's engagement by SIFMA and is prepared in the form expressly required thereby." The precise terms of this engagement are not stated in the document.

The Oliver Wyman study claimed that the Volcker Rule would make corporate bonds less liquid and therefore increase interest rates on such securities. Specifically, the Oliver Wyman study assumes that every dollar disallowed in pure proprietary trading by banks will necessarily disappear.

But if money can still be made (without subsidies), the same trading should continue in another form. For example, the bank could spin off the trading activity and associated capital at a fair market price. Alternatively, the trader – with valuable skills and experience – will raise outside capital and continue doing an equivalent version of his or her job.

If there is money to be made absent "too big to fail" subsidies, then an efficient capital market would suggest that the traders and the associated capital will remain engaged in some form. Now, however, these traders will bear more of their own downside risks. If it turns out that the previous form or extent of trading only existed because of the implicit government subsidies, then we should not mourn its end.

The Volcker Rule may actually support more liquid markets by ensuring that the banks focus on providing liquidity as market-makers – rather than draining liquidity from the market in the course of "trading to beat" institutional buyers like pension funds, university endowments, and mutual funds.

More generally, Thomas Philippon finds limited or no social benefits from increased trading activities per se.[14] The biggest disaster for the corporate bond market in recent years was a direct result of excessive risk-taking by big financial players.

So far, there is no evidence that the dire predictions in the Oliver Wyman report have actually been borne out. And if the Volcker Rule does rein in excessive betting, it will end up having a positive impact on job creators and on job creation.

[14] Thomas Philippon, "Has the U.S. Finance Industry Become Less Efficient?" http://pages.stern.nyu.edu/~tphilipp/papers/FinEff.pdf

Statement of the U.S. Chamber of Commerce

ON: *The Impact of the Volcker Rule on Job Creators, Part 1*

TO: House Financial Services Committee

BY: David C. Robertson, Treasury Strategies, Inc.

DATE: January 15, 2014

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.

Good morning Chairman Hensarling, Ranking Member Waters and members of the Financial Services Committee ("committee"). It is an honor to be invited to testify at today's hearing: ***The Impact of the Volcker Rule on Job Creators, Part 1***. We appreciate the committee's efforts to ensure the Volcker Rule is implemented in a manner that supports a stable and robust financial system and I am pleased to be able to contribute to the discussion.

I am Dave Robertson, a partner of Treasury Strategies, Inc., and I am here today on behalf of the U.S. Chamber of Commerce. Treasury Strategies is the world's leading consultancy in the area of treasury management, payments and liquidity. Our clients include the CFOs and treasurers of large and medium sized corporations as well as state and local governments, hospitals and universities. We also consult with the major global and regional banks that provide treasury and transaction services to these corporations. In thirty years of practice, we have advised many of the world's largest and most complex corporations and financial institutions as well as small and mid-sized companies.

Appearing on behalf of the U.S. Chamber of Commerce, I have participated in the Commodities and Futures Trading Commission ("CFTC") roundtable on the Volcker Rule, and my colleague Anthony Carfang has testified before the House and Senate Subcommittees on the subject as well.

In these forums, we raised concerns regarding the potential unintended consequences for non-financial businesses the Volcker Rule could cause, specifically:

- Impaired market liquidity and reduced access to credit;
- Higher costs and less certainty for borrowers;
- Restricted trading in proper and allowable businesses;
- Competitive disadvantage for U.S. businesses and financial institutions;
- Increased compliance costs for American businesses outside of the financial services sector;
- Higher bank fees for consumers and businesses;
- Less access to capital for small business and start ups;

- Shifting of risks to other, less well regulated, sectors of the economy; and

- Capital flows into offshore markets.

These concerns are very serious and very real, and the Volcker rule's impact will resonate throughout our economy. As the banking sector becomes less able to provide American businesses both liquidity and access to credit, American businesses will be compelled to reserve more idle cash, and tap more volatile and expensive forms of credit. These costs will ultimately be borne by ordinary Americans in the form of more expensive products, fewer jobs and decreased dividends. As we have stated previously, these concerns could lead to behavioral changes by financial market participants that could be harmful to economic growth and the safety and soundness of our capital markets, in turn jeopardizing the emerging economic recovery. Though a well-intentioned response to the financial crisis the Volcker Rule was designed and formalized with insufficient consideration of its impact to the economy.

While I will discuss in greater detail some of the real and potential impacts of the Volcker Rule, many of the true effects of this mammoth regulation will not be known until the conformance period ends in July, 2015. However, some problems, which impact both businesses and individuals, are coming into focus:

1. The Volcker Rule, with its broad definition of ownership, has placed in jeopardy the ability for Collateralized Loan Obligations ("CLOs") to finance businesses. CLOs provide $300 billion in business financing;

2. Corporate treasurers may be forced to build up cash reserves. These reserves could be built up through layoffs and reduction or cancellation of dividends, an important form of income for retirees; and

3. The liquidity supports of Quantitative Easing ("QE") may mask the effects of the Volcker Rule for a period of time, but the start of the wind-down has already started to boost the yields of corporate bonds.

To address these issues the Chamber recommends:

1. The passage of H.R. 3819, the "Fairness for Community Job Creators Act." and respectfully request that the bill be amended to include an exemption for CLO's;

2. The continued use of the Financial Services Committee's oversight powers to hold the Volcker Rule regulators accountable, identify and correct unforeseen consequences harmful to America's Main Street businesses; and

3. Congress review procedures for rule-writing, especially with joint agency rulemakings, to ensure fair procedures for input and comment and hold agencies accountable in the consideration of the impacts and costs on the economy and businesses.

a. Failure to understand impacts of the Volcker Rule upon capital formation of non-financial companies.

In our previous testimonies, we 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. While it appears that the regulators tried to address some of these concerns, the Rule's implications for CLOs shows that the financial regulators may have missed the mark, and this failure has real-life consequences that are harmful to the overall economy.

CLOs provide over $300 billion in financing to thousands of businesses. One surprising, and troubling, development in the final rulemaking on Volcker 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. In the final version of the Rule, the regulators, acting without prior notice, 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 could be forced to sell off debt like CLOs. 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 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 precisely the same type of power that we want our prudential regulators employing with respect to a troubled financial institution.

Banks currently own about $70 billion worth of CLO debt. Efforts to restructure this amount of debt will be overwhelming. As a result we are likely to see banks begin to sell off these performing assets, which will put downward pressure on prices and start a rush to liquidate. Ironically, this will benefit hedge funds and others who can purchase strong, performing assets at steep discounts, but it will 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. And we should be mindful of the fact that CLOs provide financing to businesses that cannot access the debt markets affordably, if at all. For many of these companies term loan financing is there only recourse.

This may only be the first wave of capital formation problems that may arise as a result of the Volcker Rule. Accordingly, the Chamber supports the passage of H.R. 3819, the "Fairness for Community Job Creators Act," and respectfully request that the bill be amended to include an exemption for CLO's.

b. Increased Cash Reserves

U.S. businesses benefit from the most efficient capital markets in the world. As a result, U.S. businesses are extremely efficient. Consider the following Treasury Strategies analysis. Companies doing business in the U.S. operate with approximately $2 trillion of cash reserves. That represents only 11% of U.S. gross domestic product. In contrast, corporate cash in the Eurozone is 20% of Eurozone GDP. In the UK, the ratio is even higher at 32%.

Highly liquid means of raising capital allow treasurers to keep less cash on hand and use a just-in-time financing system that allows companies to pay the bills and raise the capital needed to expand and create jobs.

While I will discuss this in greater detail later in this testimony why it is too early to understand the full ramifications of the final Volcker Rule, early indications are that some of the concerns we have previously raised were not unfounded and that the Volcker Rule may create barriers to entry and make our capital markets much less efficient, and accordingly, make financing for American businesses and job-creators much more expensive.

To ensure their companies have the resources needed for their companies to grow and operate, an option for treasurers would be to build up cash reserves and take productive capital out of the financial system. If U.S. corporate treasurers were to follow the Eurozone model they would need to set aside and idle an additional $1 trillion of cash.

- That $1 trillion is greater than the entire TARP program.
- It's more than the Stimulus program.
- It is even greater than the Federal Reserve's quantitative easing program, QE II.

This would seriously slow the economy to the detriment of businesses and consumers alike. To raise this extra $1 trillion cash buffer, companies may have to downsize and lay off workers, reduce inventories, postpone expansion and defer capital investment. Obviously, the economic consequences would be huge.

c. **Harmonization of the Volcker Rule is needed**

The Volcker Rule was written by 5 separate agencies—the Federal Reserve, Federal Deposit Insurance Corporation ("FDIC"), Office of the Comptroller of the Currency ("OCC"), Securities and Exchange Commission ("SEC") and the CFTC. Each of these regulators have different areas of responsibility—banking regulations, securities regulation, futures and options regulation—with different tools, histories and processes for regulation and enforcement.

Capital investment by business requires a stable and predictable regulatory environment. For the Volcker Rule to work, it is critical that its interpretation and enforcement be harmonized amongst all of the regulators to provide clear rules of the road. If the Volcker Rule is subject to three to five forms of interpretation and enforcement it will be impossible for market participants to understand or adhere to the bounds of legally permissible behavior. This will lead to either market paralysis or a system of regulatory arbitrage that undermines the safety and soundness of the capital markets. Neither one of these engenders the confidence needed for efficient capital formation.

d. Real impacts of Volcker Rule will not be known until end of conformance period and QE winds down

The Volcker Rule is a five agency rulemaking that was proposed in October, 2011 and finalized by regulators just a month ago in December, 2013. While many financial institutions have already shuttered their proprietary trading operations, the Volcker Rule will not be fully on-line until the end of the conformance period on July 21, 2015.

Because of the 18-month conformance period, it is not possible to understand the full impacts of the Volcker Rule, particularly on Main Street businesses, until the rule it is completely implemented and operational at the financial institutions.

Moreover, the continued use of the Quantitative Easing ("QE") by the Federal Reserve also masks the impact of the Volcker Rule on capital formation for American businesses. QE injects an extraordinary level of liquidity into the corporate bond market and other financial markets keeping them afloat during the financial crisis and its aftermath. How the Volcker Rule impacts the ability of market participants to issue corporate bonds, or if it is even possible to do so will not be known until the artificial supports of QE are withdrawn and a "normalized" macro environment returns.

While the end of QE may not be immediate, we are already seeing signs of how the market will react to the end of QE. However, the preliminary evidence indicates that this withdrawal will not be easy. The announcement of the Federal Reserve's reduction in asset purchases has driven portions of the yield curve higher in anticipation of reduced liquidity and corresponding decrease in demand for fixed income products. Only when the Fed finally takes its foot off the pedal will we be able to measure the true effects of the Volcker Rule on Main Street.

The conformance period should be used to identify and correct unintended consequences and regulators should provide Congress with an analysis of the impact of the QE wind down on capital formation and the interplay of the withdrawal of this support with impact of the Volcker Rule.

e. Interaction of Volcker Rule with other regulatory initiatives

Additionally, the Volcker Rule will not be implemented in a vacuum. Financial regulators, Congress, and market participants need to have a better understanding of how all the myriad regulatory initiatives interact and assess the cumulative impact of these activities.

Corporate treasurers must contend with looming money market regulations that may imperil 40% of the commercial paper market, Basel III lending requirements, Basel III disincentives for commercial lines of credits, and the implementation of derivatives regulations that may reduce the ability of businesses to mitigate risk and ensure affordable access to needed raw materials.

All of these dynamics are converging in one place—the corporate treasury – and their combined impacts upon a business's ability to raise capital and appropriately manage risk have not been vetted or thought through.

f. Process issues

The Volcker Rulemaking process also contained a number of procedural flaws that raise concerns about the level of rigor conducted in crafting the regulations implementing the Volcker Rule. First, the Volcker Rule, as proposed, contained 298 pages and asked over 1,000 questions, and regulators received over 17,000 comment letters. The final Volcker Rule contained a preamble that was over 900 pages long. A proposal of this size, complexity and breadth of agencies involved should have been re-proposed for comment before it was finalized.[1] A re-proposal would have better allowed commenters to identify unintended consequences and positioned regulators to fix them before the Volcker Rule was finalized.

For instance, a re-proposal of the Volcker Rule could have allowed the regulators to resolve the CLO and trust preferred bond issues before the rule was finalized.

Second, regulators failed to provide any sort of economic analysis of the Volcker Rule even though it is a significant rulemaking that will cost the economy more than $100 million.

This defies congressional intent. Congressman Barney Frank, in fact, stated in a congressional hearing on the Volcker Rule that cost benefit analysis "has to be applied" to the Volcker Rule Proposal.[2] The Volcker Rule shortcoming in this regard would appear to violate several applicable legal requirements and underscores the concern that the proposed regulations will have a dramatic and unforeseen negative effect on the financial markets, and the American businesses that rely on those markets for financing.

[1] *See* Chamber of Commerce letters of November 7, 2013 asking for a re-proposal of the Volcker Rule.
[2] *Joint Hearing on the Volcker Rule before the House Financial Services Subcomm. on Capital Markets and Government Sponsored Enterprises and the Subcomm. on Financial Institutions and Consumer Credit* (Jan. 18, 2012) (opening statement of Rep. Barney Frank).

Among other requirements, the SEC is statutorily required to consider the effects of certain rules on "efficiency, competition, and capital formation." These required considerations—particularly the effects on "capital formation"—are critical in connection with this rulemaking, given the fundamental role that market making and related activities have on market liquidity and the efficiency of the capital markets. In discharging these responsibilities, the SEC must "determine as best it can the economic implications of the rule it has proposed," *Chamber of Commerce v. SEC*, 412 F.3d 133, 143 (D.C. Cir. 2005), and subject that analysis to public comment, *see Chamber of Commerce v. SEC (Chamber II)*, 443 F.3d 890, 905 (D.C. Cir. 2006).

These effects on capital formation and market liquidity must be examined with more exacting review to better inform the agencies' analysis and to help minimize unnecessary regulatory burdens to companies and unintended consequences for capital formation.

The Federal Reserve, as recently as October 24, 2011, after the release of the Volcker Rule proposal was voted on, and before it was published in the Federal Register, wrote a letter to the Government Accountability Office acknowledging the need to engage in a cost-benefit analysis, and how the Federal Reserve's use of such an analysis, since 1979[3], has mirrored the provisions of regulatory reform as articulated in Executive Order 13563.[4]

Similarly, the Unfunded Mandates Reform Act, 2 U.S.C. § 1501 *et seq.*, requires agencies to prepare a budgetary impact statement for any rule likely to result in expenditures by state and local governments and private actors of $100 million or more annually. *Id.* § 1532.

It is also seems that the regulators failed to take into account issues that arose after the Volcker Rule comment period closed. After the comment period closed, the FSOC designated the first non-banks as SIFIs. When the Volcker Rule proposal was issued, the regulators specifically deferred consideration of how Section 619 of the Dodd-Frank Act would apply to designated non-banks because, at the time, the FSOC had not yet finalized the designation criteria, nor had it designated any non-banks.[5] It is still unclear how the regulators will apply Section 619 to designated non-bank SIFIs. These companies, as well as those that could be designated in the future, have no information on the requirements that the regulators will impose and have not

[3] Board of Governors of the Federal Reserve System, Statement of Policy Regarding Expanded Rulemaking procedures, 44 Fed. Reg. 3957 (1979)

[4] See letter from Scott Alvarez, General Counsel of the Federal Reserve, to Nicole Clowers, Director of Financial Markets and Community Investment of the General Accountability Office.

[5] See Volcker Rule Proposal, fn 4, pp. 66847-66848.

been given an opportunity to comment on the record. This uncertainty could have adverse impacts on liquidity management for Main Street businesses and also have a dramatic impact on asset managers who provide individual investors with vehicles to save for retirement.

Accordingly, we would respectfully request that Congress review procedures for rule-writing, especially with joint agency rulemakings, to ensure fair procedures for input and comment and hold agencies accountable in the consideration of the impacts and costs on the economy and businesses.

***

I appreciate the opportunity to appear before you today on behalf of the U.S. Chamber of Commerce. While some of the issues surrounding the Volcker Rule will not be known until QE winds down and the conformance period ends, we have already seen the first wave of impediments that the Volcker Rule has thrown into the path of capital formation by Main Street businesses. The Chamber supports the passage of H.R. 3819, the "Fairness for Community Job Creators Act," and respectfully requests that the bill be amended to include an exemption for CLO's. The conformance period should be used to identify and correct similar issues and regulators should provide Congress with an analysis of the impact of the QE wind down on capital formation and the Volcker Rule. The Financial Services Committee's oversight powers are an integral part of that process and the Chamber looks forward to working with you in the process to identify and correct unforeseen consequences harmful to America's Main Street businesses. We also ask Congress to review procedures for rule-writing, especially with joint agency rulemakings, to ensure fair procedures for input and comment and hold agencies accountable in the consideration of the impacts and costs on the economy and businesses.

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

AMERICAN
ASSOCIATION
OF BANK DIRECTORS

National Capital Office
Suite 700
1250 24th Street, NW
Washington, DC 20037
Telephone: (202) 463-4888
Facsimile: (202) 349-8080
www.aabd.org

January 14, 2014

The Honorable Jeb Hensarling
Chairman
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

Re: Volcker Rule and Treatment of CDO TruPS

Dear Chairman Hensarling and Ranking Member Waters:

Your hearing tomorrow on the federal agencies' last minute efforts to force banks to divest of their legal investments in CDO TruPS is an opportunity not only to weigh in on the agencies' startling misinterpretation of the requirements of the Volcker Rule (Section 619 of the Dodd-Frank Act) but also to explore how the agencies might have reached such a flawed interpretation.

While the subject matter of the hearing appears to focus on the Volcker Rule, the Committee may wish to conduct oversight hearings on other actions taken by the federal banking agencies against holders of TruPS investments in the Basel III capital rules, and in the capital rules relating to the risk-weighting effects on ownership interests in TruPS as explained below.

You and the members of your committee are to be commended for taking a strong interest in this issue. You and many of your committee's members have introduced or co-sponsored legislation that would overturn the ill-advised action of the agencies to force a divestiture of CDO TruPS under the false premise that such a forced sale is required by the Volcker Rule.

The American Association of Bank Directors represents the interests of bank and savings institution directors. Many bank boards of directors approved or authorized management to purchase CDO TruPS as legal and sound debt investments. They were legal when made. At the time the boards approved or authorized the investments, they had no inkling that some day, the agencies would force divestitures of such investments at a substantial loss to their institutions. Our membership has a substantial interest in the rule of law applying to their institutions in a manner that would be fair and consistent and allow them to make informed decisions without having to anticipate inappropriate and unforeseeable changes in interpretations of laws and regulations that would negatively affect those decisions.

Ever since the agencies (FDIC, OCC, Federal Reserve, and SEC) issued their final rule on December 10, 2013, chaos has reigned.

The final regulations were issued on December 10th, only 21 days prior to the fiscal year end for most banks and bank holding companies. A required divestiture of CDO TruPS will force many banks to write down these legal investments to market value, resulting in some instances in substantial losses that could have been avoided had the banks been allowed to hold them to maturity.

The problem is exacerbated by the fact that the new definition of "ownership interests" was never foreshadowed by the agencies, so no one was prepared for it. On the contrary, representations were made by the banking agencies that community banks were not the target of the Volcker Rule. The banking industry believed those representations.

The proposed rule's definition of "ownership interest" as published in the Federal Register on November 7, 2011 did not provide notice to the banking industry or the general public that community and other banks would be forced to divest their TruPS investments. I have been advised that none of the 18,000 comment letters received following the publication of the proposed rule addressed concerns about the forced sale of CDO TruPS. No one knew.

There would also have been no awareness that Congress intended such a result. Prohibitions on certain investments in Section 619 of the Dodd-Frank Act clearly do not include debt investments. Section 619 is entirely focused on "equity, partnership or other **ownership** interests" in covered funds, which investments in CDO TruPS most assuredly are not. If Congress had intended that debt investments to be covered in the statute, it would have included the word 'debt." The debt securities typically sold to investors in CDO TruPS were stratified into multiple tranches, each of which had different interest rates - which were fixed rate or based on a spread over a LIBOR or other index rate, final maturity dates, seniority and priority in receiving payments of interest and principal out of available cash from the payment of interest and principal on the pool's assets.

Because the definition of "ownership interests" was never vetted in the proposed rulemaking, chaos has ensued. Had the definition been proposed rather than suddenly adopted in final form, the agencies would have received comments from the banking industry seeking clarity on certain imprecise language in the final definition or questioning whether Congress intended that CDO TruPS would be covered by the definition.

It is also troubling that the agencies are now suggesting that CDO TruPS investments **may** be subject to divestiture even though they are debt investments that the agencies allowed banks to invest in **because** they were debt and not equity.

In addition, it is inexplicable that banks may still invest in trust preferred securities of individual bank holding companies which are generally viewed as having a higher risk than investing in pools of trust preferred securities, which have the advantage of diversification. Banks that purchased the more senior tranches of CDO TruPS investments have additional protection.

The chaos is taking various forms.

Some public bank holding companies are issuing statements that they will take, in some cases, substantial hits to their capital and income as a result of the final regulation; others have not.

Some believe that the final regulations do not require divestiture of all or most CDO TruPS investments. Others believe it is likely that the final regulation requires CDO TruPS investments under the final regulations to be divested. Some are not waiting for the agencies but instead are selling their interests, often at a substantial loss.

The agencies have it in their power to resolve this quagmire - which they created - prior to the time when year-end financials must be filed.

Having undoubtedly reviewed all of the indentures and offering circulars of each of the CDO TruPS pools in examinations of numerous banks to assure that the investments were debt and not equity investments (equity investments would have been prohibited by banking statutes and regulations), the agencies are in a position to resolve the problem immediately. They know these investments as well as any party.

They can take one of several actions:

1. Make a statement that it was not the intent of the agencies to require CDO TruPS investments, other than perhaps the bottom or "income" tranche (which we understand banks did not invest in), to be divested and the agencies will not take any enforcement action against any bank that decides not to divest those investments.
2. Based on the agencies' prior position that CDO TruPS investments were permissible investments for banks because they were debt and not equity, the agencies will not change that position when they apply the final regulation's definition of "ownership interest."
3. Rescind the regulation for further study or rescind the definition of "ownership interests" as it might apply to CDO TruPS investments and agree to reconsider the matter at some future date.

The consequences of agency inaction are significant.

Banks may decide that it is more prudent to sell their CDO TruPS investments before the market for these securities declines any further in anticipation that there will be a huge supply of such investments due to the bank divestiture requirement. Even so, the sale will likely be at prices that will be significantly below the carrying value of those investments.

Those who decide not to sell but to write down their investments run the risk that they have understated their capital and earnings. Those who decide not to sell and not to write down their investments run the risk that they have overstated their capital and earnings. Securities laws will place these banks and bank holding companies at risk.

The agencies have the power to correct this problem. They need to act now.

Your committee should also explore how the agencies could have decided to add a definition of "ownership interests" that could be of such variance from the letter of Section 619 of the Dodd-Frank Act and without the appropriate notice and comment process that the Administrative Procedures Act requires.

The agencies had three and one-half years to review the language of Section 619 and, in particular, the definition of "ownership interests" and more than two years after the proposed rules were published, yet it was only in the waning days of 2013 that they acted, without the benefit of public comment, to make a radical departure from the proposed rule and from the intent of Congress. How did this happen?

Do the agencies have in place the controls and systems to assure that they are meeting the requirements of the Administrative Procedures Act, which, at its heart, is a law that requires a full airing of the merits of a proposal, including a cost/benefit analysis.

In their report titled "The Volcker Rule: Community Bank Applicability" dated December 10, 2013, the federal banking agencies wrote that "only a small number of community banks own...collateralized debt obligations (CDOs) (including CDOs backed by trust-preferred securities)..." This is factually incorrect; hundreds of banks own CDO TruPS investments and the consequences for many may be severe if they are forced to sell or account for their investments at market value.

What was the source of this agency statement and why did the agencies not have better information on which to make decisions on the final wording of the rule?

Why did the agencies not propose a new rule that would have provided the banking industry and the general public the opportunity to comment on the new definition of "ownership interest", instead of adopting it in the final rule without public review or comment?

We urge the Committee to ask the questions it needs to ask to understand how it did happen.

Finally, for the subject of another hearing, we recommend that the Committee review the actions of the federal banking agencies to require that banks deduct from their CET1 capital the amount of TruPS investments in excess of 10% of their CET1 capital, and apply risk weightings for TruPS investments, in some cases, in excess of 1,000%.

Sincerely,

David Baris
Executive Director

INDEPENDENT COMMUNITY BANKERS of AMERICA®

January 14, 2014

Volcker Rule CDO TruPS provisions pose a critical threat to community banks and must be fixed

On behalf of the nearly 7,000 community banks represented by the Independent Community Bankers of America, thank you for convening today's hearing titled: "The Impact of the Volcker Rule." The final Volcker Rule, as issued on December 10, would have a harsh and immediate impact on some 300 community banks that hold collateralized debt obligations (CDOs) backed by trust preferred securities (TruPS). The December 10 rule would cause an irreversible impact on the earnings and capital of these banks. We know of several community banks that would literally be put out of business if this rule stands.

ICBA is currently evaluating the interim final rule released late today by the agencies to address this problem and will assess whether additional remedies are warranted. ICBA is grateful to Chairman Hensarling and Chairman Capito for introducing legislation (H.R. 3819) that would remedy this injustice by allowing banks to retain CDO TruPS issued before December 10, 2013, the date of the final rule. Senators Mark Kirk, Mike Crapo, and Jerry Moran have introduced Senate legislation (S. 1907) that would also provide an effective remedy. We also thank Ranking Member Maxine Waters and the Financial Services Committee Democrats for writing to the regulators to express their concerns regarding the impact of the final Volcker Rule. Congress never intended the Volcker Rule to jeopardize community bank TruPS.

The CDO TruPS investments in question were structured and sold beginning in 2000 with the purpose of helping community banks raise capital to serve their communities. The investments always were highly rated and performed well until the financial crisis of 2008. Community banks had every reason to believe they would have the right to own these investments until maturity.

The intent of the Volcker Rule was to prohibit proprietary trading by the largest banks and the ownership of hedge funds and private equity funds. When the final rule was issued, community bankers were frankly shocked to learn that it required them to divest their holdings of CDO TruPS by July 2015. This unanticipated requirement was not included in the proposed Volcker Rule. What's worse, the divestment requirement, though not immediate, would require that these investments be immediately impaired through earnings and regulatory capital under "other-than-temporary-impairment" (OTTI) accounting standards. Because the divestment requirement would immediately drive down the fair value of these instruments, the write downs would be based on fire sale prices that bear no relation to their true long-term value. In many cases, this would wipe out a bank's earnings and impair capital. As noted above, it would cause the failure of several community banks that we are aware of.

The agencies' December 19 effort to clarify the application of the rule did not provided adequate assurances to community bank investors. We are currently evaluating the agencies newly-released revisions to the Volcker Rule which are intended to address our concerns. The interest of the House Financial Services Committee, including the convening of this hearing and the legislation noted above, has been extremely helpful.

Thank you again for moving expeditiously to address this critical threat community banks and to the economic recovery.

One Mission. Community Banks.

1615 L Street NW, Suite 900, Washington, DC 20036 ▪ 202-659-8111 ▪ Fax 202-659-9216 ▪ www.icba.org

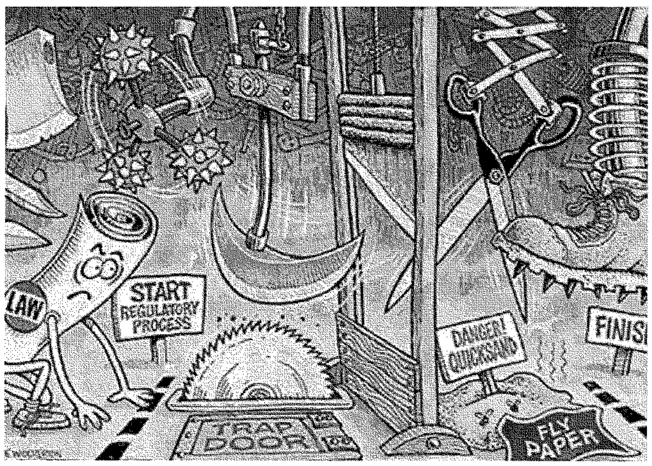
http://www.washingtonmonthly.com/magazine/march_april_2013/features/he_who_makes_the_rules043315.php?page=all

Washington Monthly, March/April 2013

March/ April 2013 He Who Makes the Rules

Barack Obama's biggest second-term challenge isn't guns or immigration. It's saving his biggest first-term achievements, like the Dodd-Frank law, from being dismembered by lobbyists and conservative jurists in the shadowy, Byzantine "rule-making" process.

By Haley Sweetland Edwards



In late 2010, Bart Chilton, one of three Democratic commissioners at the U.S. Commodity Futures Trading Commission (CFTC), walked into an upper-floor suite of an executive office building to meet with four top muckety-mucks at one of the biggest financial institutions in the world.

There were a handful of staff members present, but it was a pretty small gathering—one, it turns out, that Chilton would never forget.

The main topic Chilton hoped to discuss that day was the CFTC's pending rule on what are known as "position limits." If implemented properly, position limits would put a leash on speculation in the commodities market by making it harder for heavyweight traders at places like Goldman Sachs and JPMorgan Chase to corner a market, make a killing for themselves, and screw up prices for the rest of us. Position limits are also one of many ways to tamp down the amount of risk big institutions can take on, which keeps them from going belly up and minimizes the chance taxpayers will have to bail them out.

The financial institution Chilton was meeting with that day was a big commodities exchange, which is like a stock exchange except that instead of trading stocks they trade derivatives based on the value of actual products, like oil and gas. Chilton wouldn't say which major commodities exchange he was meeting with that day, but suffice it to say two of the biggest—the Chicago Mercantile Exchange and Intercontinental Exchange—have a lot to lose from federally administered position limits. To them, the more derivatives traded, the better. They've been fighting the CFTC's attempts to establish position limits for years.

The passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in July 2010 seemed to promise meaningful reform on this front. The law includes Section 737, which explicitly directs the CFTC to establish position limits and lays out detailed guidelines on how they should do so. "The Commission shall by rule, regulation or order establish limits on the amount of positions, as appropriate," it reads.

Still, even with the strength of the law behind him, Chilton waited until the end of the meeting to broach what he knew would be a tense subject. He began diplomatically. Now that the CFTC was required by law to establish position limits, his commission wanted to do so "in a fashion that made sense—one that was sensitive to, but not necessarily reflective of, the views of the exchange," he told the executives.

Chilton's gracious overture fell flat. His hosts, who had been openly discussing other topics moments before, were suddenly silent. They deferred instead to their top lawyer, who explained that the exchange's interpretation of Section 737 was that the CFTC was not required to establish position limits at all.

Chilton was blindsided. While other parts of Dodd-Frank were, admittedly, vague and ambiguous and otherwise frustrating to those, like him, who were tasked with writing the hundreds of rules associated with the act, Section 737 didn't exactly pull any punches. *The Commission shall establish limits on the amount of positions, as appropriate.*

"You gotta be kidding," Chilton told the executives. "The law is very clear here. The congressional intent is clear."

But the executives stood their ground. Their lawyer quietly referred Chilton to the end of the sentence in question: *as appropriate*. Those two little words, the lawyer said, clearly modify the verb "shall." Therefore, the statute can be interpreted as saying that the commission *shall*—but only if appropriate—establish position limits, he explained.

Anyone with a passable command of the English language should, faced with that argument, feel both dismay and a grudging sort of admiration. After all, given the context in which that sentence appears, the sheer brazenness of such a linguistic sleight of hand is, in a way, inspired. It's the kind of thing that would make Dick Cheney and John Yoo proud. Joseph Heller has written books on less.

But it's still, rather obviously, just that: a linguistic sleight of hand. The words "as appropriate" have appeared in statutes governing the CFTC's authority to implement position limits for at least forty years without challenge. In fact, the CFTC used the authority of that exact line, complete with its "as appropriate," to establish position limits on grain commodities decades ago. Even those who drafted Dodd-Frank later weighed in, saying they had intended for the language to explicitly instruct the CFTC to establish position limits *at levels that were appropriate*. The summary of Dodd-Frank, drafted by the Congressional Research Service, doesn't quibble either: "Sec. 737 Directs the CFTC to establish position limits," it reads. No ifs, ands, or "as appropriate"s.

"But this kind of thing"—manipulating the minutiae—"is how the game is played," said Bartlett Naylor, a financial policy advocate at Public Citizen, one of a handful of public interest groups tracking the rule-making process for Dodd-Frank. Since the law passed, the financial industry has been spending billions of dollars on lawyers and lobbyists, all of whom have been charged with one task: weaken the thing. One strategy has been to carve loopholes into the language of the law, Naylor said. A verb. An imprecise noun. A single sentence in an 876-page statute. "With a thousand lawyers on your payroll, that's nothing."

In the meeting that day, Chilton couldn't believe what he was hearing. He pointed out to the executives that, in Dodd-Frank, Congress had not only directed the CFTC to establish position limits, it had also imposed a deadline asking the commission to do so months before almost any other rule. It was obvious, he argued, that it was a matter of *when* position limits would be in place. Not *if*.

But the executives refused to discuss the matter further. The meeting ended abruptly, and Chilton wandered out into the hallway, dazed and reeling. One of the muckety-mucks from the meeting walked with him to the elevator. While they waited, away from the rest of the group, Chilton turned to his host. "You guys have got to be kidding about this 'as appropriate' stuff, right?" he said.

"I know," the muckety-muck replied, admitting it was a stretch. He let out a little chuckle—"but that's what we're going with."

"He *laughed*," Chilton told me recently, remembering that day. "He was laughing about how ludicrous it was."

A couple of months after that inauspicious meeting, the CFTC released a proposed rule establishing position limits on oil, gas, coffee, and twenty-five other commodities markets. They received about 15,000 letters during the public comment period and spent the next six months reading through all of them, incorporating the suggestions into the draft, meeting with industry and consumer groups, and revising the rule. Fearful of being sued, the CFTC held off voting on the rule several times and agreed to delay its implementation for a year to help financial institutions comply. Finally, in October 2011, the CFTC issued a final rule. It was a victory, but a short-lived one.

Two months later, two powerful industry groups, who together represent the biggest speculators in the world, hired Eugene Scalia, the son of Supreme Court Justice Antonin Scalia, as their lead counsel, and launched a lawsuit against the CFTC. The Securities Industry and Financial Markets Association and the International Swaps and Derivatives Association were suing on the same grounds that the exchange executives' lawyer had cited in that meeting with Chilton a year earlier: the CFTC had not demonstrated that establishing position limits was necessary and appropriate, they claimed. They also argued that the commission had not sufficiently studied the economic impact of the rule.

House Democrats and nineteen senators, some of whom had drafted Dodd-Frank, petitioned the court to rule in favor of the CFTC, a handful of op-eds beseeched judges to do the right thing, and financial reform advocates called foul.

None of it made a difference. In September 2012, the U.S. Court for the District of Columbia Circuit overturned the CFTC's rule. In the decision, the court wrote that the commission lacked a "clear and unambiguous mandate" to set position limits without first demonstrating that they were necessary and appropriate. And with that, more than two years after the passage of Dodd-Frank, there were still no federally administered position limits for any commodities except grain, and the CFTC was back to square one. The muckety-mucks at the exchanges rejoiced, as appropriate.

Welcome, dear readers, to the seventh circle of bureaucratic hell.

As Obama begins his second term, all the talk in Washington is about whether ongoing congressional gridlock and soul-crushing partisanship will block the administration from achieving significant legislative victories, be they immigration reform, a big fiscal deal, or an infrastructure bank. But at least as important to the future of the country and to the president's own legacy is whether that potentially game-changing legislation he signed in his first term—like the Affordable Care Act and Dodd-Frank, as well as a slew of other landmark bills—is actually implemented at all.

It may seem counterintuitive, but those big hunks of legislation, despite being technically the law of the land, filed away in the federal code, don't mean anything yet. They are, in the words of one CFTC official, "nothing but words on paper" until they're broken down into effective rules, implemented, and enforced by an agency. Rules are where the rubber of our legislation hits the road of real life. To put that another way, if a rule emerges from a regulatory agency weak or riddled with loopholes, or if it's killed entirely—like the CFTC's rule on position limits—it is, in effect, almost as if that part of the law had not passed to begin with.

As of now, there's no guarantee that either Obamacare or Dodd-Frank will be made into rules that actually do what lawmakers intended. That's partly because the rule-making process is a dangerous place for a law to go. We might imagine it as a fairly boring assembly line—a series of gray-faced bureaucrats diligently stamping laws into rules—but in reality, it's more of a treacherous, whirling-hatchet-lined gauntlet. There are three main areas on this gauntlet where a rule can be sliced, diced, gouged, or otherwise weakened beyond recognition.

The first is in the agency itself, where industry lobbyists enjoy outsized influence in meetings and comment letters, on rule makers' access to vital information, and on the interpretation of the law itself.

The second is in court, where industry groups can sue an agency and have a rule killed on a variety of grounds, some of which make sense and some of which most definitely do not.

The third is in Congress, where an entire law can be retroactively gutted or poked through with loopholes, or where an agency can be quietly starved to death through appropriations bills.

And here's the really alarming part: rules run this gauntlet largely behind closed doors, supervised by people we don't elect, whose names we don't know, while neither the media nor great swaths of the otherwise informed public are paying any attention at all. That's not because we don't care what happens; we do. After all, millions of us spent the better part of a year closely monitoring the battles to pass Obamacare and Dodd-Frank. Remember? It was high drama! Every detail was faithfully chronicled in front-page headlines and long disquisitions on *The Rachel Maddow Show*; in countless posts by wonky bloggers, who dissected every in and out, every committee hearing, every new study about the public option or the Volcker Rule.

That kind of stuff is the Washington journalist's bread and butter: the artful, insidious process by which a bill becomes a law. And since reporters know how the process works, how influence gets wielded and where the pressure points are, the rest of us were able to follow along closely. We knew what to root for, what to keep our eye on, and which decision makers in Washington we could remind to do the right thing.

But fast-forward a couple of years, and as the fate of those very same laws is being determined in the rule-making process we've found ourselves distracted by new shiny objects, like women in combat and how Pennsylvania will allocate its electoral votes in 2016. Part of the reason for that, no doubt, is that many Washington journalists, underpaid, overworked, and required to write a dozen blog posts a day, don't have time to dedicate to following the rule-making process. Others simply don't understand it.

Regardless, the result is that the rest of us haven't followed the progress of these landmark laws in anywhere near the same way that we followed it during the legislative process. And in our inattention we've made it infinitely easier for industry lobbyists and members of Congress who voted against the laws to begin with to destroy them by subtle, nuanced, backdoor means. By quibbling over "as appropriate"s and misplaced verbs. By crafting crafty legal arguments and drowning understaffed rule makers in industry-funded hogwash. This is the way a law ends: not with a bang but with a whimper.

For purposes of illustrating the problem, this article will focus on just one of these landmark laws, Dodd-Frank. It passed more than two and a half years ago, in July 2010, but most of its rules have yet to make it through the rule-making gauntlet. While many liberals have already written it off as a total failure—some were, in fact, writing its eulogy the day it passed—it's time we had some perspective. It's true that it's not as strong as many experts on financial markets had called for. It's true that it doesn't break up the big banks, nor fundamentally change the structure of our financial system. We may have been hoping for, say, a bulletproof SUV with state-of-the-art airbags; what we got instead are a few seat belts that need to be welded into our old rig. But as of now, those jury-rigged seat belts are the only thing we've got, and given the gridlock on the Hill they're all we're likely to get. And the truth is that they're strong enough that the financial industry is willing to spend billions of dollars to keep them from being installed.

As of now, roughly two-thirds of the 400-odd rules expected to come from Dodd-Frank have yet to be finalized. That includes big, potentially game-changing rules governing inappropriate risk taking and international subsidiaries of American banks, and how exactly we'll go about regulating derivatives. In the next year or so, the vast majority of these rules will be launched down the rule-making gauntlet. The necessary first step in assuring that they come out the other end as strong as they should be—or that they come out the other end at all—is to understand the challenges they'll face along the way.

The basic rules of rule making

The rule-making process is governed by the Administrative Procedure Act, which became law in 1946, in response to the New Deal-era expansion of the federal bureaucracy. In the late 1930s and early '40s, all the new agencies were dancing to their own beat; the APA established a system-wide metronome. Since then, a handful of other laws have been passed, including the Regulatory Flexibility Act, Paperwork Reduction Act, Government in the Sunshine Act, and Congressional Review Act, which also govern parts of the process; but for the most part the APA is the foundation.

Every stage in the rule-making process is guided by the APA. It begins the moment a law is passed and shunted off to the regulatory agency that will oversee its implementation. Once it's in the agency, the APA governs the activities of a team of rule makers—researchers, analysts, economists, and lawyers—who do a bunch of fact gathering, perform studies, and hold a ton of informational meetings in an attempt to get a handle on how best to abide by the intention of the law and how to apply that intention to real life. Since big laws like Obamacare and Dodd-Frank deal with complex issues, Congress often makes the statutes deliberately vague, deferring to rule makers' technical expertise and policy decisions, and giving them a significant amount of authority on how to interpret a law. All of that interpretation generally happens in the very beginning of the rule-making process, which is called the Notice of Proposed Rulemaking, or, in the acronymic parlance of the federal bureaucracy, NPRM.

After spending months and months in the NPRM process, the agency eventually publishes a proposed rule, on which, the APA stipulates, the public gets an "adequate" amount of time to comment. Usually, that's about sixty days, but it can be shorter or longer, depending on how complex or controversial a rule is. After that, the rule makers revise the rule again, taking into account concerns raised by regulated industries and the public's comment letters.

From there, executive branch agencies like the Food and Drug Administration and the Environmental Protection Agency send their rules to the White House Office of Management and Budget's Office of Information and Regulatory Affairs (OIRA), which reviews the projected costs and benefits of those agencies' major new rules, as well as the suggestions of other agencies, before the final rule is published and implemented. At independent agencies like the Securities and Exchange Commission (SEC) and the CFTC, a bipartisan panel of commissioners publicly debates and votes on the rule—a process that often results in further revisions and compromises.

Like the rest of us, rule makers use the Track Changes feature in Microsoft Word, which assigns a different color font to each contributor. By the time a complex rule has made it through this whole process, it is "lit up like a Christmas tree," said Leland Beck, who worked for various agencies for thirty years and practiced administrative law. "A rule becomes a decision on all the comments and revisions and compromises between agencies and all the individuals who got their hands on it." Eventually the agency publishes a final rule, which is implemented and enforced. *Voilá* .

Or that's how it's supposed to work. But like many things in Washington, that's just half the story. The rule-making process is actually a much messier, much more cacophonous affair, dictated to a large degree by lawmakers who voted against the law to begin with, and by industry groups who would often prefer that no rules be implemented at all. In the last decade, conservative members of Congress have built ever-higher hurdles that agencies must clear, and done so while cutting their staff and budgets.

Meanwhile, since the passage of Dodd-Frank, financial industry groups have also sabotaged parts of the APA's carefully plodding process, overwhelming rule makers with biased information and fear tactics and threatening to sue the agencies over every perceived infraction. That's a big reason why agencies have missed so many of their deadlines for implementing Dodd-Frank—a subtlety reporters frequently miss. (See "Why Agencies Are Always Missing Their Deadlines.")

"It's just this constant, never-ending onslaught," a former SEC staffer told me. "You're doing battle every day."

The Gauntlet, Stage 1: Asymmetric warfare in rule making

Public interest and consumer advocates tend to describe the fight over the rules of Dodd-Frank in martial terms. "It's like World War II," said Dennis Kelleher, the president and CEO of the nonprofit Better Markets. "There's the Pacific theater, the Atlantic, the European, the African theater—we're fighting on all fronts." Former Senator Ted Kaufman, an outspoken advocate for financial reform, says it's "more like guerrilla warfare." The reformers are trying "to make it at the margins, but they're totally outgunned," he said.

The financial industry certainly has a spectacularly enormous arsenal. Since the passage of Dodd-Frank, the industry has spent an estimated $1.5 billion on registered lobbyists alone—a number that most dismiss as comically low, as it doesn't take into account the industry's much more influential allies and proxies, including a battalion of powerful trade groups, like the U.S. Chamber of Commerce, Business Roundtable, and American Bankers Association. It also doesn't take into account the public relations firms and think tanks, or the silos of campaign cash

the industry has dumped into lawmakers' reelect-
ion campaigns.

"The amount of money and resources they're willing to deploy to protect the status quo is unlimited," said Kelleher. His company, Better Markets—one of the slickest and most vocal financial reform shops in town—has a $2 million annual budget, Kelleher said, which is about how much the financial industry spends on its lobbying team every day and a half.

While there's no record of the total amount the industry has spent, it's clear that there's no shortage of money in its war chest. In the last quarter of 2010, just a few months after Dodd-Frank passed, the financial industry raked in nearly $58 billion in profits alone—about 30 percent of all U.S. profits that quarter. With that sort of bottom line, spending a hundred million or so to kill a single rule that could "cost" them a couple billion in profits is a pretty good return on investment.

In 2009, researchers at the University of Kansas and Washington and Lee University studied the return on corporations' investment in lobbying for the American Jobs Creation Act, which included a one-time corporate tax break, and found that it was a staggering 22,000 percent. That means that for every dollar the corporations spent lobbying, they got $220 in tax benefits. Based on the billions Wall Street has spent to weaken Dodd-Frank, it seems that they have done similar math.

One thing all that industry money buys is a well-disciplined army. According to public records, representatives from the financial industry have met with the dozen or so agencies that regulate them thousands of times in the past two and a half years. According to the Sunlight Foundation, the top twenty banks and banking associations met with just three agencies—the Treasury, the Federal Reserve, and the CFTC—an average of 12.5 times per week, for a total of 1,298 meetings over the two-year period from July 2010 to July 2012. JPMorgan Chase and Goldman Sachs alone met with those agencies 356 times. That's 114 *more* times than all the financial reform groups combined.

"For every one hundred meetings I have, only one of them is with a consumer group or citizens' organization," said Chilton. While it's good that regulated industries have a chance to express their opinions and concerns to those who regulate them, he said, "the deck is just stacked so heavily against average people."

It's not just the quantity of meetings, it's the quality, too. Kimberly Krawiec, a professor at Duke Law School, published a study last year analyzing the role of external influence during the NPRM period of Dodd-Frank's Volcker Rule. (The Volcker Rule would ban proprietary trading, which is when banks trade for their own profits, and not on behalf of their customers, making them more likely to fail.) In her study, Krawiec found that while public interest organizations met with agencies in giant group meetings on the same day, head honchos from the industry often met with the agencies' top staff alone. Former Goldman Sachs CEO Lloyd Blankfein, for instance, was not expected to share the floor.

That's not an insignificant advantage, considering that the NPRM period is when "the majority of the actual agenda setting and rule making happens," Krawiec said. Because APA stipulations require that the public get a fair shake at commenting on a rule before it is implemented, a proposed rule can't be too different from the final rule or an agency can get sued, she explained. That has the effect of pushing most of the rule making to the very beginning of the process, which is also the least transparent, since agencies don't have to publish what they're up to or who their staff is meeting with during this time. Because of increased transparency efforts surrounding Dodd-Frank, agencies have been encouraged to publish all of the meetings that occur during the NPRM period—hence Krawiec's study.

Krawiec has also found that after the Volcker Rule was proposed the vast majority of substantive public comment letters were from the financial industry, trade groups, and their various proxies—lawyers, lobbyists, and under-written think tanks—all of whom have the time and money to present extensive, if wildly biased, legal and economic arguments. Often, industry lawyers will simply rewrite entire paragraphs of the proposed rule, fashioning loopholes or limiting an agency's scope with a single, well-placed adjective or an ambiguous verb. Whether a rule survives that change, whether it then can be effectively implemented and enforced, really does come down to such trivialities. In the rule-making process, the minutiae aren't incidental to the rule; they *are* the rule. (Don't believe me? The U.S. Supreme Court recently heard a case on a 1934 SEC rule on fraud that centered entirely on different definitions of the verb "to make.")

Industry lobbyists are well aware that they don't need to outright kill a rule; they need only to maim it, and it's as good as dead. In fact, it's better than that: it's on the books, the newspapers cover it—it looks like a success for financial reform—but industry remains as unfettered as it was before. "That happens all the time," said a former rule maker at the CFTC, who spoke on the condition of anonymity. "The public interest groups get the headline, but if you look at the details, the industry group has actually won. There's an order of magnitude between the public interest groups' and the industry groups' attention to detail." When I spoke to an industry lobbyist in mid-January, he put that another way. "We can't kill it, but we can try to keep it from doing any damage," he said.

Jeff Connaughton, a lobbyist turned crusader for financial reform, said that the "ubiquitous presence of Wall Street" goes beyond meetings and legalese in comment letters. In his book *The Payoff: Why Wall Street Always Wins*, he describes the tight-knit relationships between industry lobbyists and proxies and government officials as the "Blob," which, in his experience, "oozed through the halls of government and immobilized the legislative and regulatory apparatus, thereby preserving the status quo." Many in the Blob are married to one another and move fluidly from industry to government and back again, he told me. For example, CFTC Commissioner Jill Sommers, who recently announced her resignation, is married to Speaker of the House John Boehner's top aide. She used to work at the Chicago Mercantile Exchange, one of the biggest exchanges in the world, which is overseen by the CFTC; she also worked at the International Swaps and Derivatives Association, the organization that later sued the CFTC to overturn the rule on position limits.

In this light, the traditional notion of "regulatory capture" doesn't go far enough. Instead, we should think of it as "cultural capture," writes the political scientist James Kwak. There may be no bags of cash exchanging hands, but that doesn't matter when regulators, like many of the rest of us, have been steeped for so long in the idea that Wall Street produces the best and brightest our society has to offer. Regulators often look up to industry representatives, or know them personally, which begets "the familiar effect of relationships," Kwak wrote in *Preventing Regulatory Capture*, a compilation of essays that will be published this year by Cambridge University Press in collaboration with the Tobin Project, a nonprofit research center. "You are more favorably disposed toward someone you have shared cookies with, or at least it is harder for you to take some action that harms her interests."

Like many reformers, Connaughton points a finger at the so-called "revolving door," which sends former bureaucrats into the private sector and vice versa, blurring the line between the regulators and the regulated. From 2006 to 2010, 219 former SEC employees filed 789 statements saying that they would be representing a lobbyist or industry group in front of the SEC, according to the Project on Government Oversight. A complex law like Dodd-Frank accelerates that cycle, Connaughton said, as industry has even more incentive to hire people directly from the agencies to help them navigate the new regulations. "Put your time in at one of these regulatory agencies while they're doing the Dodd-Frank rule making and it's a license to print money when you come out," he told me.

Of course, the revolving door doesn't explain everything. A lot of the agencies are packed with ten-, fifteen-, and twenty-year veteran rule makers, who are motivated by the esprit de corps and have no interest in leaving for industry. "Money isn't everything. If you leave, there's the feeling that you're in the audience, and no longer on the public policy stage," the former CFTC rule maker told me. "That, and at the agency you're actually performing a public service. People recognize that. It's a factor."

Also, the revolving door revolves both ways. Industry leaders who are later appointed as commissioners sometimes provide a valuable asset to rule makers. In agency parlance, "they know where the bodies are buried." In many instances, these former industry officials head agencies at the end of their careers and have no intention of returning to the private sector. CFTC Chairman Gary Gensler, for example, spent eighteen years at Goldman Sachs, eventually rising to partner, before becoming one of the most outspoken advocates in recent years for better regulation. (In 1934, President Franklin Delano Roosevelt appointed Joseph Kennedy to head the brand-new SEC for this exact reason.)

Another swinging mace in this stage of the rule-making gauntlet is what Kelleher, the head of Better Markets, calls the "Wall Street Fog Machine." "They come at you with this jargon," he said. "They want to make you feel like it's too complicated for you to understand. You're stupid, and they're the only ones who get it—that's the end game." This is particularly true when it comes to financial products, like customized swaps, which traders on Wall Street have spent the last decade designing precisely in order to swindle their clients.

"That's how you make money. You make it so complicated the clients don't understand what it is they're buying and selling, or how much risk they're taking on," said Alexis Goldstein, who worked in cash equity and equity derivatives on Wall Street for several years, first at Merrill Lynch and then at Deutsche Bank, before joining the reform movement. The more complex the product, the higher the commission you can charge, and the less likely it is that there will be copycats driving down your profit margins with increased competition, she explained. In other words, complexity "isn't a side effect of the system—it's how the system was designed."

Partly as a result of that business model, the system really is complicated—extraordinarily so. But that doesn't mean it can't *also* be regulated in the right ways, reformers say. How exactly that should be done is often a bone of contention. Take those customized swaps, for example. Right now, they're traded in the private "over the counter" market, which means that they're contracted bilaterally, often between a single bank and a counterparty during a phone call, and they aren't transparent. Dodd-Frank gives the CFTC the power to regulate them, and many suggest that all trades should be conducted in clearinghouses, where customers can easily compare prices and are therefore less likely to be fleeced. Banks claim they're too complex to be traded in that way.

Kelleher says that's "just plain false." A customized swap is nothing more than a bundle of so-called "two-legged" swaps, he said. If you unbundle them, which the banks themselves do, for lots of reasons, like hedging, there's no reason we can't regulate them, he said. Just as Wall Street used the excuse of complexity to hoodwink their clients, they're now using the excuse of complexity to hoodwink their regulators—"it's the greatest coup they've managed to pull off," Kelleher said.

Others argue that customized swaps should be regulated but clearinghouses aren't the answer. They worry that if all such trading is moved to clearinghouses, then those institutions will balloon, leaving them vulnerable to collapse, said Peter J. Ryan, a fellow at the University of California Washington Center whose research focuses on financial services policymaking. In other words, the clearinghouses themselves could become too big to fail.

The real problem here is not that rule makers can't understand Wall Street's complex financial products. It's that they often don't have enough information about those products or the systems that govern them to see the whole picture, and therefore to choose the best possible way to regulate. As it stands, rule makers, as well as the teams of agency researchers who help them, rely to a large degree on industry to provide data about things like banks' internal trading. For proprietary reasons, only the banks have access to much of that information, and they have no incentive to share it. When regulators request data in public comment letters, industry rarely provides it; when they do, it's often incomplete, one-sided, or missing crucial variables. "If there's a datum that supports their argument, they produce it. If not, they don't—why would they?" said Naylor of Public Citizen.

This is one of the main reasons the Volcker Rule has been such a mess. It requires that regulators determine what's proprietary trading (when banks trade with their capital base for their own profit) and what's market making (the backbone of a bank's basic business model). A Credit Suisse lobbyist claimed recently that the metrics in the Volcker Rule were flawed since, in a test run, the bank found that proprietary trading and market making were indistinguishable. Credit Suisse's claim will go into the rule makers' record, which, in turn, can be used as evidence in court, should implementing agencies be sued. In that situation, rule makers and reformers are left without a card to play. "We can't dispute [their claim], because Credit Suisse owns the data and won't share it publicly," Naylor said.

While Dodd-Frank provides rule makers with access to a variety of new information sources—the new Office of Financial Research, the SEC's Consolidated Audit Trail, the CFTC's Swaps Report—none of these tools do enough yet to keep them ahead of the financial industry's constantly morphing business model, which changes every time an analyst invents a new product or a new way to trade it. "The regulators need to be able to pool all of this disparate information together into a complete picture of the financial system, which I'm not sure if they have the funding and coordination to do," said Marcus Stanley, the policy director at Americans for Financial Reform, a coalition of consumer, labor, small business, and public interest groups. If a shape shifter shows up as a mouse, building a mouse trap will only get you so far.

It is in some ways a Sisyphean task. Here you have a group of rule makers—lawyers, economists, analysts, and specialists—sitting around a table. On one side, they've got the language of Dodd-Frank, which requires them, by congressional mandate, to effectively regulate new, never-before-regulated products in never-before-regulated markets that change by the month. On the other side, they've got a pile of reports, nine out of ten of which were provided by the same industry they're trying to rein in. Meanwhile, industry lobbyists and lawyers are crowding into their conference rooms on a nearly daily basis, flooding their in-boxes with comment letters, and telling them that if they do something wrong, they'll be personally responsible for squelching financial innovation and destroying the economy. "They're scared to death," said Naylor of Public Citizen, who compares the effect the financial industry has on rule makers to Stockholm syndrome. "No one wants to be the one who writes the rule that screws up the entire financial system."

Wall Street is well aware of rule makers' human vulnerabilities. Last year, when the SEC was writing rules governing money markets, the U.S. Chamber of Commerce, one of the financial industry's staunchest allies, launched a public relations campaign in D.C.'s Union Station, which abuts the SEC building. They papered the place with dozens of bright purple and orange posters, billboards, and backlit dioramas on the train platforms and above the fare machines, asserting that money markets are strong: "Why risk changing them now?" It is not coincidental that a good number of rule makers began and ended their daily commute beneath those very banners. "We certainly want to get the attention of those who are capable of giving us the answers," David Hirschmann, a Chamber of Commerce official, told Bloomberg at the time. One imagines him stifling a smirk.

Given the many whirling hatchets in this stage in the regulatory gauntlet, it's a miracle any rules have emerged in the last couple years reasonably unscathed. But they have. When that happens, industry can appeal to the second stage in the gauntlet: litigation.

The Gauntlet, Stage 2: Cost-benefit analysis and a conservative court

On a sweltering summer day in 2011, the U.S. Court of Appeals for the D.C. Circuit—the de facto second most powerful court in the land, and the body that oversees the agencies—sent shockwaves through the regulatory apparatus.

In a now-infamous case, *Business Roundtable vs. SEC*, a three-judge panel decided in favor of two of the financial industry's biggest backers and overturned the SEC's so-called "proxy access" rule. The rule would have made it easier for shareholders to elect their own candidates to corporate boards, allowing investors to put the brakes on out-of-control CEO pay. In the past decade, it has attempted to establish a proxy access rule on three separate occasions, but each time it was cowed into submission by industry lobbyists claiming that the rule would destroy corporate growth. In 2011, emboldened by the language of Dodd-Frank, which explicitly authorizes the SEC to establish a proxy access rule, the agency tried once again.

Almost immediately after the final rule was published, the Business Roundtable and the U.S. Chamber of Commerce sued the SEC on the grounds that the agency's cost-benefit analysis was inadequate. The judges agreed, marking the first time that the court had overturned a rule explicitly authorized by Dodd-Frank. But that's not the part that sent shockwaves through the regulatory apparatus. The D.C. Circuit has overturned dozens of regulations over the years, including six SEC rules in the previous seven years, for lots of reasons, including inadequate cost-benefit analyses.

What sent the shockwaves was that this case didn't seem to have anything to do with cost-benefit analysis at all. In the vitriolic decision, the panel of judges, all of whom were appointed by Republican presidents, lamented that due to "unutterably mindless" reasoning, the SEC had "failed once again" in its cost-benefit analysis. But the court never cited how exactly the agency's twenty-three-page economic impact report could have done better. It simply appeared to *disagree* with the agency's policy choice—and that, apparently, was grounds enough to overturn the rule.

"It was a shot across the bow," said Michael Greenberger, a former regulator and professor at the University of Maryland Carey School of Law. The decision set a radical new precedent that would affect not only the SEC but all the independent agencies tasked with implementing Dodd-Frank, he said. It would also raise a powerful question: Should specific policy judgments be made by the agencies or the courts? "It upset the balance of the power," Greenberger said.

Part of the issue here is that the D.C. Circuit is packed high with conservative judges. Eight out of eleven on that bench were appointed by Republicans; despite four vacancies, Obama's nominations have been stymied consistently by Republicans in Congress. The three-judge panel that decided *Business Roundtable* included two Reagan appointees, Judge Douglas Ginsburg and Chief Judge David Sentelle, a Jesse Helms protégé. (That's the same Sentelle, by the way, who headed the panel that fired Whitewater independent counsel Robert Fiske, a moderate Republican, and replaced him with Kenneth Starr.) The third judge was George W. Bush appointee and consummate Ayn Randian Janice Rogers Brown. All three have made a bit of a name for themselves over the years as conservative activists, unafraid to mold precedent to fit their ideological ends. Their decision in *Business Roundtable* didn't break that mold.

In one section, for instance, the judges ask why the SEC would have dismissed public comments suggesting that proxy access could exact a significant economic cost to corporations. Judge Ginsburg writes, "One commenter, for example, submitted an empirical study showing that 'when dissident directors win board seats, those firms underperform peers by 19 to 40% over the two years following the proxy contest.' " But hold the phone. Or, better yet: WTF? Ginsburg fails to note here that the "one commenter" in question *is one of the plaintiffs*, the Business Roundtable. And as for that "empirical study"? It was conducted by an economic consulting group hired *by that same plaintiff*. In the rest of the decision, Ginsburg appears to ignore the precedent set by the foundational 1984 *Chevron* case, which, among other things, stressed that judges must afford "deference" to an agency's interpretation of a statute, especially when it's "evaluating scientific data within its technical expertise."

Questionable judicial behavior aside, the *Business Roundtable* decision marked "the culmination of a trend empowering regulated entities to strike down regulations almost at will," wrote Bruce Kraus, a former counsel at the SEC, in a subsequent report. For one, it established an inherent bias—reformers cannot, after all, challenge a rule in court to make it *stronger*. For another, it opened up the floodgates for future suits. If two of the industry's most powerful organizations could sue the SEC and overturn a rule on such grounds, it was suddenly feasible for industry groups to sue *any* agency and overturn *any* new Dodd-Frank rule using the same arguments.

It was a point that did not go unnoticed by industry. "I would hope the agencies are taking to heart the potential consequences for Dodd-Frank rules," said lead counsel Eugene Scalia, after the case was decided. (Scalia was also lead counsel on the case that overturned the CFTC's rule on position limits a year later.) Industry groups have since brought a half-dozen more cases against agencies on practically identical grounds.

The *Business Roundtable* decision had the immediate effect of adding a whole new lethal section to the regulatory gauntlet, this time complete with flypaper and trapdoors. In the months following, the SEC's progress through the Dodd-Frank rule making is estimated to have slowed by half as they struggled to "bulletproof" their rules from future lawsuits. ("They have to be *more* than bulletproof," Chilton told me, when I asked him if that was a factor for the CFTC, too. "They have to be layered in Kevlar. We go way beyond the requirements of the law.")

The decision also had the effect of tipping the balance of power at independent agencies. By making an agency's cost-benefit analysis the centerpiece of the litigation, economic models now hold disproportionate weight. If a single economist at an agency produces a report, based on a single model, and "demonstrates" that a rule would exact steep costs from a given industry, it acts like a trump card, according to former staffers at the SEC and the CFTC. Even if the majority of that economist's colleagues disagree with him, his report will enter the public record, where it can be cited in a subsequent lawsuit and end up determining if a rule is implemented or not. And economic models are like statistics; you can always find one that supports your position.

Along those same lines, in the wake of *Business Roundtable* a single commissioner—one of five on a bipartisan panel—now has the de facto power to torpedo a rule simply by questioning its economic impact in a public forum. For example, if a Republican commissioner disagrees with a rule, he will, under normal circumstances, be required to compromise with his fellow commissioners, or risk being simply outvoted. If at least three of his colleagues disagree with him, the rule will pass. The *Business Roundtable* decision seemed to suggest that a single commissioner's verbal expression of disapproval could be used later as grounds for litigation and as evidence in court. Indeed, a year after the *Business Roundtable* decision, in the CFTC's position limits case, part of Scalia's argument rested on the fact that former CFTC Commissioner Michael Dunn has expressed misgivings about the rule.

"When a commissioner says publicly, 'I'm concerned about the economic impact of this rule,' that's enough to lay the groundwork for a future case," said Chilton. Several former rule makers and staffers at the CFTC and the SEC told me they would "not be surprised," given the wording of these public expressions of disapproval, if these commissions were getting their language directly from industry lawyers.

The most profound weapon the *Business Roundtable* decision introduced into the regulatory gauntlet is stupefying uncertainty. "It has been paralyzing for the agencies," the former CFTC rule maker told me. How extensive must their cost-benefit analyses be? What kind of costs must be measured? And costs to *whom*—the industry or the investors? What were the criteria? "It's like going into a class and not having any idea how your professor grades," he said. "Everyone is trying to figure out how to move forward without getting sued."

In the past, when an agency has been sued over a rule, that litigation has often marked the end of the rule altogether. Most are never re-proposed, and those that are often emerge pitifully weak. It also has the effect of sending an agency back to the starting line, where it must run the gauntlet yet again, only this time with more attention from Congress—which is often the most lethal weapon of all.

The Gauntlet, Stage 3: Congress's retroactive attacks

Many of us think of Congress as passing a law, shunting it off to the agencies, then wiping its hands of the matter. Not the case. Lawmakers, and particularly those who voted against Dodd-Frank to begin with, have a number of tools up their sleeves, which they've been using consistently since 2010 in an attempt to retroactively weaken the act.

One way has been to go after the regulators personally, lambasting them publically, smearing their reputations, and wasting their time. In the wake of the *Business Roundtable* decision, for example, the House Financial Services Committee summoned former SEC Chairwoman Mary Schapiro to testify before Congress about why the SEC had failed in its cost-benefit analysis. The Senate Banking Committee, obliquely questioning her competency as a leader, also requested a series of investigations into why her agency's cost-benefit analyses were falling short. While lawmakers have a legitimate right to ask the heads of regulatory agencies to testify, in the past few years Congress has seemed to blur the line between inquiries and something more akin to the Inquisition. All told, since 2009 Schapiro has been called to testify before Congress forty-two times.

"On one hand, those attempts to create a scandal don't mean anything," said Lisa Donner, the executive director of Americans for Financial Reform, referring to Congress's harassment of Schapiro late last year. "But on the other hand, those performances waste an enormous amount of time. It plays a role. It's intimidating."

Also in the wake of *Business Roundtable*, Alabama Republican Senator Richard Shelby, as if on cue, wielded another of Congress's favorite weapons to kill a law in the regulatory process. He introduced a bill suspending all the independent agencies' major rules until they could be subjected to OIRA, the Office of Management and Budget's subsidiary, which vets the cost-benefit analyses for new executive branch rules. Had that bill passed, it would have had the effect of stopping all Dodd-Frank rule making in its tracks indefinitely. It didn't pass, but last summer a similar bill—this one bipartisan—the Independent Agency Regulatory Analysis Act, was introduced and passed in the House, before failing, in the nick of time, in the Senate.

In the two and a half years since Dodd-Frank passed, lawmakers have introduced dozens of other such bills, so-called "technical amendments," that purport to change or clarify certain sections of Dodd-Frank but would actually gut, defang, or kill the act entirely. Because the bills are presented as mere tweaks to an existing law, and because industry cash is the only way many of these congressmen will get reelected, the bills are often voted on quickly, sometimes even coming up for a voice vote—a procedure usually reserved for uncontroversial issues.

Take the Swap Jurisdiction Certainty Act, for example. That bipartisan bill would have prevented the CFTC and the SEC from regulating derivatives trades conducted by American companies' subsidiaries overseas. That's insanity. First, if any of those subsidiaries—much less hundreds of them at once—were to fail, they would threaten and potentially take down the U.S. market. (Indeed, during the 2008 crash, U.S. taxpayer money was used to bail out those foreign-based subsidiaries too, for precisely that reason.) And second, if you only regulate the derivatives traded by American institutions on U.S. soil, American traders will simply scoot their business over to the thousands of subsidiaries abroad, making those unregulated markets even larger and more dangerous. In other words, had this bipartisan, innocent-looking bill passed, it would have undermined all the provisions in Dodd-Frank that attempt to regulate the derivatives market at all.

While the efforts of public interest groups and financial reform advocates, like Americans for Financial Reform, have succeeded thus far in keeping any of these bills from passing, they still have an effect behind the scenes. "There are instances where regulators say, 'I know what we want to do with this, but if we go too far, Congress is just going to wipe out the whole thing, and I want what we're doing to last,' " said Stanley, the policy director at Americans for Financial Reform. "That's a calculation."

A much more common weapon congressional opponents can wield after a law has been passed is a little less dramatic. By attaching riders to appropriations bills, Congress can simply forbid an agency from using its money to enforce one specific rule or another—and, of course, an unenforced rule is a dead rule. Lawmakers can do that even if Congress has passed another law that pointedly mandates that an agency take the action in question. In 2011, for instance, the House Appropriations Committee, which is dominated by Republicans, attached a rider to its funding bill preventing the U.S. Department of Agriculture from using its funds to finalize and implement a series of specific rules helping small farmers fight back against big livestock and poultry corporations. Despite the Obama administration's attempts to get those exact rules implemented, the rider passed, tying the USDA's hands and sending small farmers adrift. (For more on this, see Lina Khan, "Obama's Game of Chicken.")

Using the same mechanism, Congress also has the power to defund or severely underfund any agency that relies on congressional appropriations, including the CFTC and the SEC—a guillotine it has successfully used for decades. Just last year, for instance, the House Appropriations Committee cut the CFTC's annual budget by $25 million, leaving it with an anemic $180 million. (For a sense of how little money this is, consider that San Bernardino, a county of about two million people in California, spends more than $180 million just on its public works department.) In 2011, congressional opponents of financial regulation blocked any increase in the SEC's budget, despite or perhaps because of the agency's massive new workload with Dodd-Frank. The Republicans' argument against funding the independent agencies is delightfully absurd: since the agencies have not written and enforced rules fast enough, Congress should "punish" them, rather than "reward" them with adequate funding.

Yet another weapon Congress uses to retroactively kill bills in the rule-making process is to block presidential appointments. In January, another three-judge panel at the D.C. Circuit, led by the same conservative crusader who voted to overturn the SEC's proxy access rule, Judge Sentelle, ruled that Obama's recess appointments were unconstitutional. It was a radical decision that has the potential to invalidate rules and guidelines promulgated by the National Labor Relations Board and the Consumer Financial Protection Bureau for the previous year. The decision may be reconsidered (and, heaven help us, affirmed) by the Supreme Court, but in the meantime it brings the independent agencies further into Congress's orbit.

Congressional Republicans are already using the decision to strong-arm Congress into weakening the CFPB's independence. The only way Congress will allow Obama to reappoint CFPB Director Richard Cordray, or to install another head, Republican lawmakers say, is if the agency's funding is brought under congressional appropriations controls. It's an underhanded move that would eliminate the CFPB's strongest asset—that it's *not* subject to Congress's manipulative purse strings—and may have the effect of gutting the entire agency, one of the strongest things that's come out of Dodd-Frank thus far.

Gunning for the finish line

It's true that Dodd-Frank started out as a compromise. "It was compromise on top of a compromise—a pile of compromises," said Kelleher of Better Markets. And that's what we can expect from the rule-making process too, he said. As it stands, how the law has fared in its journey down the regulatory gauntlet has been mixed.

Some rules have been spectacularly hacked to death. Take, for example, a joint rule by the SEC and the CFTC, which was intended to force swaps dealers into maintaining more capital and to prevent horrible scenarios, like the collapse of AIG, from ever happening again. When it was first proposed, the rule required that every dealer trading more than $100 million in swaps should be subject to regulatory oversight. A bill proposed by Illinois Republican Representative Randy Hultgren raised that threshold to $3 billion, but the agencies, intimidated by lobbyists' doomsday scenarios and under the constant threat of litigation, raised it again: to $8 billion. The rule that eventually emerged now exempts about two-thirds of all swaps dealers from new capital requirements.

Scenarios like that can be deflating for reformers, but there have been wins, too. The CFPB remains a major success for consumer and investor advocates, and the SEC's rule on whistleblowers appears to have emerged fairly intact. The CFTC's brand-new Swap Data Repositories, which were designed to collect data about over-the-counter derivatives transactions, are also up and running, with the potential to shed some much-needed light on that shady industry. Whether the new repositories will be useful to regulators, or whether they will be undermined by a future lawsuit or lack of funding, is still unclear.

In some arenas, most notably the D.C. Circuit's activist bench, reformers have faced crushing defeats. Yet all is not lost. In a case this past December, the U.S. District Court for D.C., a notch below the D.C. Circuit, handed the industry its first loss in years, deciding in favor of the CFTC's rule requiring registration of mutual funds that engage in derivatives trading. It also marked the end of a five-case winning streak in lead counsel Eugene Scalia's battle against agency rules. Judge Beryl A. Howell, an Obama appointee, decided against the U.S. Chamber of Commerce and the Investment Company Institute. (Both are now appealing that case to the D.C. Circuit.)

The Dodd-Frank rules that, against all odds, have emerged relatively intact underscore an important point: those who favor strong regulations are not without shields to protect rules against the many whirling weapons along the regulatory gauntlet. But in order to be effective, of course, those shields have to be used.

First and foremost, the White House has to get more involved in defending its own legislative achievements from being gutted in the rule-making process. In addition to appointing more judges to the D.C. Circuit (and that's no guarantee of success; the judge who decided against the CFTC's position limits rule was a Democratic appointee), the administration should deploy its best Justice Department lawyers to defend against the industry's court attacks on Dodd-Frank rules. It should aggressively push to fill vacancies at the agencies with pro-regulation commissioners and other agency heads, and fight harder for bigger agency budgets. And the president himself should shine a spotlight on the process, and support the work rule makers do by paying personal visits to the agencies.

Second, the administration and its allies in Congress must address as quickly as possible the asymmetry of information in the agencies. In order to do their jobs, regulators must be armed with objective information to offset the biased or incomplete reports they receive from industry. This is particularly important for a small, underfunded agency like the CFTC, which doesn't have the stable of researchers and economists employed by some of its brethren, including the Fed, the CFPB, and the FDIC.

The good news is that Dodd-Frank mandated the creation of a new office whose mission, in part, is to correct this imbalance of information. Housed in the Treasury and funded by bank fees, the new Office of Financial Research was conceived as a kind of giant weather station monitoring the financial industry in order to detect potential "storms" before they arrive. To that end, it's statutorily authorized to gather, with subpoena power if necessary, granular-level data from financial institutions, including information about banks' trading partners, positions, and transactions, and to make that data available to other regulatory agencies. The only question is whether the OFC will have the political backing it needs to fulfill those ends.

As of now, it has a very small budget and an advisory board heavily weighted with industry insiders. It's also facing extraordinary political opposition, mostly from congressional Republicans, who have called for nothing less than its immediate abolishment, arguing that it compromises data security and encroaches on the private sector. Making sure that the OFC survives and overcomes any legal challenges to its ability to share key information with regulators should be a top agenda item for congressional Democrats and the new treasury secretary, Jacob Lew.

Third, reformers and reform-minded analysts, lawyers, and academics need to do a better job of making their voices heard in the agencies. The Administrative Procedure Act, which governs the rule-making process, painstakingly enshrines public commentary, but as of now the vast majority of the substantive comments are coming from industry groups and their proxies, including bought-and-paid-for think tanks, trade groups, and consulting firms, which have the time and legal expertise to dedicate to such things. Launching a counterinsurgency in kind will obviously require a pretty chunk of change. Perhaps it's a place where foundations can make a real difference. If more individuals and groups weighed in with smart ideas and substantive research to counter industry, it could help strengthen the rule makers' hands.

Rule makers read and make note of every comment letter, and those letters have a cumulative effect of pushing policy, staff members at the SEC and the CFTC told me. That's particularly true in instances where a rule-making team believes the best public policy differs from what industry is advocating. "To the extent that there was already an argument for a given position, a public letter will give a team support. There's a sense of 'See? Other people think this too,' " a former SEC staffer told me.

Reform groups like Americans for Financial Reform, Better Markets, and Public Citizen have thus far done a heroic job writing substantive, evidence-based letters of concern and organizing public letter-writing campaigns. Groups like Occupy the SEC, which is run by people with direct experience in the financial industry, have also submitted long, well-informed reports to the agencies and engaged with rule makers personally. Those voices make a big difference. But they go only part of the way toward countering the overwhelming influence that industry has enjoyed.

Fourth, what's needed is the vigilance of the wider public. That may seem unreasonable to expect—who has the time or inclination to follow the grammatical arcana of rule making as it moves through the process? But in an age of Wikipedia, when millions of people write and edit tomes on obscure and complex issues on a daily basis, there's no reason in theory why more Americans couldn't weigh in on regulations that most of them clearly favor. Nearly 75 percent of voters, Republicans and Democrats alike, support "tougher" rules and enforcement for Wall Street financial institutions, according to a 2012 poll commissioned by a coalition of consumer, reform, and public interest groups.

Those same citizens should also prod their members of Congress. The political scientist Susan Webb Yackee has found that the attention of lawmakers is one of the primary factors that can help curb industry influence in the regulatory process. In the stew of congressional power struggles, and with the financial industry furiously underwriting lawmakers' reelection campaigns, members of Congress have a variety of reasons *not* to stick their necks out. Their constituents should insist that they do.

Finally, there's no mystery about how to stir up public attention: the press needs to do a better job of covering the regulatory process. Again, that may seem unreasonable, especially in an age when for-profit news has lost its business model. But it needs to be done. Those same editors, reporters, bloggers, and wonky producers at *The Rachel Maddow Show* who followed the passage of Dodd-Frank so closely two and a half years ago should tune in again.

As of early February, fewer than 150 of the estimated 400 rules from Dodd-Frank had been finalized, according to Davis Polk & Wardwell, a law firm that keeps track of such things. Nearly the same number had not even been *proposed* yet. All together, almost 65 percent of the law, including potentially significant hunks, like rules on extraterritoriality and systemic risk, have yet to be finalized.

In the next year or so, the vast majority of these new rules will enter the regulatory gauntlet, while agencies and industry will watch carefully as those that have already been finalized are implemented and enforced. Industry and its allies in Congress will scream bloody murder and claim that Dodd-Frank rules are imposing an insurmountable burden on industry, the economy, and the American people. Meanwhile, the agencies either will attempt to hold the line or, without the glaring light of public scrutiny, they will allow industry to take the lead again. What happens in the next year or two will have a profound effect not only on Dodd-Frank, but on the future of our financial industry. "We're in the fifth inning," said Kelleher. "The only way to guarantee you'll lose is if you walk out before the end of the game."

Haley Sweetland Edwards is an editor of the Washington Monthly.

Questions from Representative Foster to Kenneth E. Bentsen, Jr.

Question:
You noted in your testimony that the lack of an explicit mechanism or process for ongoing regulatory coordination and resolution. How do you believe we in Congress can best track the uniformity of the application of the Volcker Rule across agencies for financial institutions?

Answer:
As noted in our testimony, we strongly believe there is an oversight role for Congress to play in ensuring ongoing regulatory coordination and a consistent application of the Rule. Congress, as it has begun to do during the recent series of hearings, needs to continue to evaluate the impact of the Rule on capital formation and Main Street job creators. While we applaud the recent announcement of the establishment of an "interagency working group" to address interpretive questions, we believe Congress and the affected market participants will need to carefully monitor the work of this group to avoid the negative consequences of differing or conflicting interpretations and enforcement.

Bloomberg

U.S. Posts Record December Surplus on Fannie Mae Payments

By Kasia Klimasinska - Jan 13, 2014

The U.S. posted a record December budget surplus as higher payroll taxes, payments from Fannie Mae and Freddie Mac, and a declining unemployment rate helped improve the government's finances.

Revenue exceeded spending by $53.2 billion last month, compared with a $1.19 billion deficit in December 2012, the Treasury Department said today in Washington. The median estimate in a Bloomberg survey of 29 economists was for a $44 billion surplus, the same as the Congressional Budget Office's prediction.

The 1.2 percentage-points drop in the nation's jobless rate to 6.7 percent in 2013 was the steepest calendar-year decline since 1983. The strengthening economy and swelling tax revenue cut the country's deficit as a share of gross domestic product by more than half to $680.3 billion in the fiscal year ended Sept. 30 from a record $1.42 trillion in 2009.

"We continue to see economic conditions improve, which is being reflected in the budget deficits continuing to narrow," said Michael Brown, an economist at Wells Fargo Securities LLC in Charlotte, North Carolina.

The yield on the benchmark 10-year Treasury note fell three basis points, or 0.03 percentage point, to 2.83 percent as of 4:59 p.m. in New York, touching the lowest level in a month.

Today's report showed revenue increased to $283.2 billion last month from $269.5 billion in December 2012. Spending totaled $230 billion compared with $270.7 billion a year earlier, it showed.

Narrower Deficits

The deficit totaled $173.6 billion in the first three months of fiscal 2014, compared with a $293.3 billion shortfall from October through December 2012, according to the report.

Payments to the Treasury from Fannie Mae and Freddie Mac were about $34 billion more last month than they were a year earlier, according to the report.

Fannie Mae and Freddie Mac have taken $187.5 billion in U.S. aid since they were taken into conservatorship in 2008. They've returned $185.2 billion, which is counted as a return on the nearly 80 percent stakes the government holds, not as repayment.

Employers added 74,000 workers in December, the smallest gain since January 2011, a Labor Department report showed Jan. 10. Economists say the coldest December since 2009 and above-normal snowfall restrained hiring. Job growth in 2013 totaled 2.19 million, the third straight year exceeding 2 million and sending unemployment to the lowest level since October 2008.

Spending Debate

While Congress agreed to set the government spending through Sept. 30 at $1.01 trillion, they still must pass legalization this week detailing funding government operations, including the military and health-care services. Senators are also at a stalemate over renewing U.S. unemployment benefits for the long-term jobless until offsetting cuts are found elsewhere in the budget.

Republicans are also yet to determine what they want in exchange for agreeing to raise the debt ceiling, which has been suspended through Feb. 7. Treasury Secretary Jacob J. Lew said the U.S. will exhaust its borrowing authority shortly after that and urged Congress to raise the borrowing limit as soon as possible.

A Treasury official, speaking on condition of anonymity, said today that there is no change in the department's estimate that it could use extraordinary measures to stay under the debt ceiling until late February or early March.

A previous congressional agreement led to higher payroll taxes in January 2013 and spending cuts known as sequestration that kicked in in March.

"The deficit is going down, will continue to go down as percentage of GDP and in nominal terms through about 2018, 2019 under current forecasts," said Stan Collender, executive vice president at Qorvis/MSLGROUP in Washington and a former congressional appropriations aide. "It will essentially cease to be much of an economic issue over the next five years."

To contact the reporter on this story: Kasia Klimasinska in Washington at kklimasinska@bloomberg.net

To contact the editor responsible for this story: Chris Wellisz at cwellisz@bloomberg.net

AMENDMENT TO COMMITTEE PRINT OFFERED BY MR. MILLER OF NORTH CAROLINA AND MR. PERLMUTTER OF COLORADO

Page 71, after line 7, insert the following new section (and redesignate succeeding sections accordingly):

SEC. 1111. RESTRICTION ON PROPRIETARY TRADING BY DESIGNATED FINANCIAL HOLDING COMPANIES.

(a) IN GENERAL.—If the Board determines that propriety trading by a financial holding company subject to stricter standards poses an existing or foreseeable threat to the safety and soundness of such company or to the financial stability of the United States, the Board may prohibit such company from engaging in propriety trading.

(b) EXCEPTIONS PERMITTED.—The Board may exempt from the prohibition of subparagraph (a) proprietary trading that the Board determines to be ancillary to other operations of such company and not to pose a threat to the safety and soundness of such company or to the financial stability of the United States, including—

(1) making a market in securities issued by such company;

(2) hedging or managing risk;

(3) determining the market value of assets of such company; and

(4) propriety trading for such other purposes allowed by the Board by rule.

(c) RULEMAKING AUTHORITY.—The primary financial regulatory agencies of banks and bank holding companies shall jointly issue regulations to carry out this section.

(d) EFFECTIVE DATE.—The provisions of this section shall take effect after the end of the 180-day period beginning on the date of the enactment of this title.

(e) PROPRIETARY TRADING DEFINED.—For purposes of this section and with respect to a company, the term "proprietary trading" means the trading of stocks, bonds, options, commodities, derivatives, or other financial instruments with the company's own money and for the company's own account.