The Fixed Income Market and Securitizations after Dodd-Frank Act and Basel III: Serving the Real Economy and Promoting Financial Stability

Testimony before the U.S. House of Representatives
Subcommittee on Capital Markets and Government-Sponsored Enterprises

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Thank you Chairman Garrett and Ranking Member Maloney for the opportunity to testify on this important topic. I am the Managing Director of Economic Policy at the Center for American Progress, where I help lead our research on financial markets. Today, I aim to discuss (1) quantitative and qualitative evidence regarding how fixed income markets are performing and (2) offer some constructive suggestions on how you might wish to move forward with respect to them.

Fixed Income Markets are Better Thanks to Dodd-Frank and Basel III

<u>The Data Overwhelming Demonstrates That Past Forecasts of Catastrophe Were Simply Wrong</u>

First, I want to firmly rebut the claims that there is a so-called "liquidity crisis," or even a risk of one, caused by new and burdensome regulations. It simply is not true. The arguments have gone as follows: new Basel III capital charges and the Volcker Rule's limits on taking and holding positions will make dealer banks unable to take the inventories that markets need to remain liquid. Clients will not be able to sell, spreads will rise, and the costs of financing will rise to corporations and the real economy.[1]

[1] An industry-funded study on the Volcker Rule's impact on liquidity forecast that the Volcker Rule would devastate liquidity. Amongst several methodological errors, assumed its conclusion by taking 2007 and 2008 market conditions as the basis behind certain key calculations. It turned out to be entirely wrong. See Simon Johnson,

Just as Paul Volcker and others indicated early on, *the reality is almost entirely the opposite*.[2] Don't just take my word for it. The researchers and leadership of the Federal Reserve Bank of New York, FINRA (the securities market self-regulatory organization), and a range of independent researchers have all concluded that while there are changes in certain characteristics of the market, most measurements of liquidity today are as good, or *better*, than pre-crisis levels.[3]

First, the primary functioning of the bond markets – the placement of debt issued by the real economy – has performed spectacularly. Corporate bond issuance is robust and borrowing costs are near historic lows.[4] The dollar volume of corporate bond issuances in 2015 was a record $1.5 trillion, compared to around $750 billion in 2005.[5] The number of unique issuances has grown consistently and is higher than prior to the crisis.[6] (See figure below.)

"Should We Trust Paid Experts on the Volcker Rule?" Economix, *N.Y. Times*, Jan. 19, 2012, http://economix.blogs.nytimes.com/2012/01/19/should-we-trust-paid-experts-on-the-volcker-rule/?_r=0.

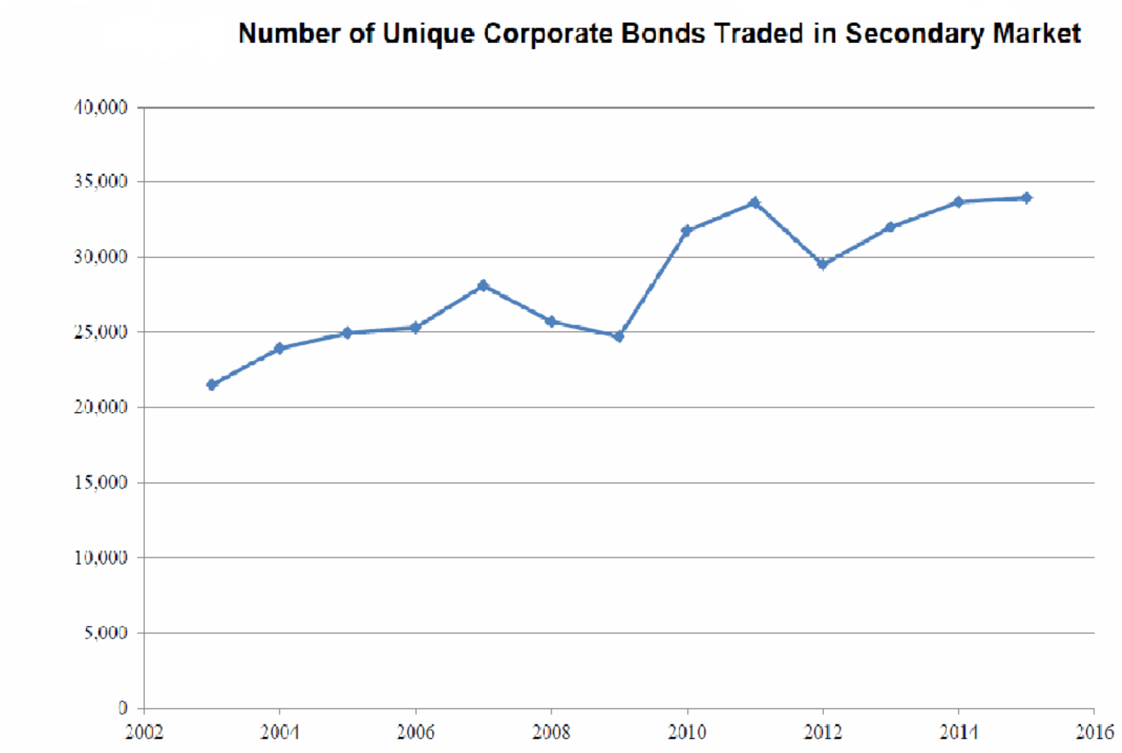
[2] Yalman Onaran and Dakin Campbell, Did Bank Rules Kill Liquidity? Volcker, Frank Respond, Oct. 20, 2014, http://www.bloomberg.com/news/articles/2014-10-20/did-bank-rules-kill-liquidity-volcker-frank-respond.

[3] Tobias Adrian, Michael Fleming, Or Shachar, and Erik Vogt, "Has U.S. Corporate Bond Market Liquidity Deteriorated?," *Liberty Street Economics*, Oct. 5, 2015, http://libertystreeteconomics.newyorkfed.org/2015/10/has-us-corporate-bond-market-liquidity-deteriorated.html#.Vsn6hOZSFdc; Bruce Mizrach, *Analysis of Corporate Bond Liquidity*, FINRA, Dec. 10, 2015, https://www.finra.org/sites/default/files/OCE_researchnote_liquidity_2015_12.pdf, see also http://www.finra.org/newsroom/2015/corporate-bond-liquidity-healthy-most-measures-finra-research; Dudley, supra; Staff Q4 2015 report on corporate bond market liquidity, provided to the Subcommittee by the staff of the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission; Francesco Trebbi and Kairong Xiao, "Regulation and Market Liquidity," Dec. 23, 2015. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2687465.

[4] See, e.g., Cordell Eddings, "Corporate Bond Sales Surge Above $23 Billion as Apple Sells Debt," *Bloomberg News*, Feb. 16, 2016, http://www.bloomberg.com/news/articles/2016-02-16/corporate-bond-deals-take-off-with-apple-and-ibm-tapping-market.

[5] SIFMA, http://www.sifma.org/research/statistics.aspx.

[6] Mizrach, supra.

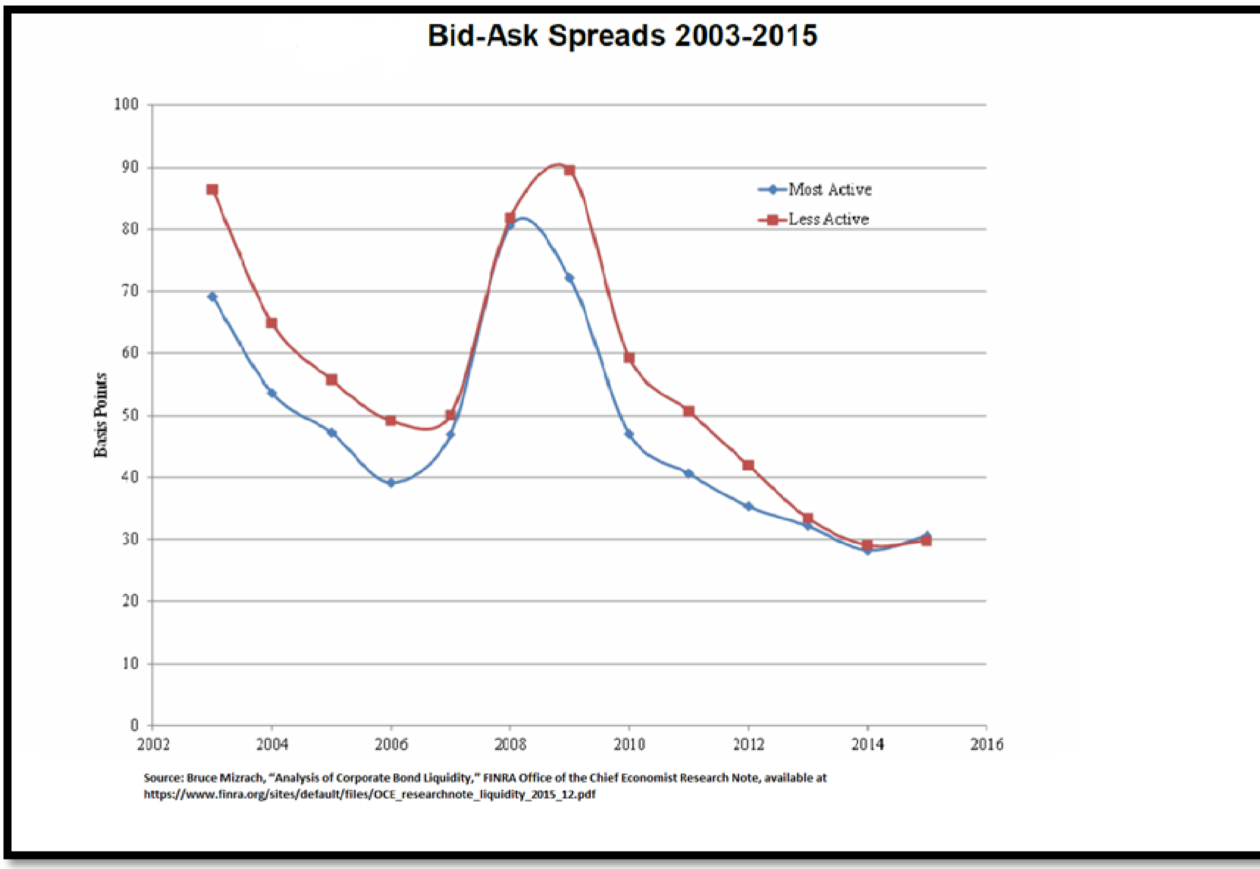


Source: Bruce Mizrach, "Analysis of Corporate Bond Liquidity," FINRA Office of the Chief Economist Research Note, available at https://www.finra.org/sites/default/files/OCE_researchnote_liquidity_2015_12.pdf

The securitization markets are also functioning reasonably well. Securitized product issuance rebounded nicely since the passage of the Dodd-Frank Act. And while it peaked at $225 billion in 2014, at $194 billion in 2015 it is largely in line with issuance in the early 2000s.[7] Instead, regulators have been concerned about frothy securitization markets and weaker underwriting.[8]

[7] SIFMA, http://www.sifma.org/research/statistics.aspx.
[8] See, e.g. Jeremy Stein, "Overheating in Credit Markets: Origins, Measurement, and Policy Responses," Feb. 7, 2013, http://www.federalreserve.gov/newsevents/speech/stein20130207a.htm; Lawrence Delevingne, "Blackstone: High-yield bonds, leveraged loans still 'frothy,'" June 2 2015, http://www.cnbc.com/2015/06/02/blackstone-high-yield-bonds-leveraged-loans-still-frothy.html.; Matthew Boesler, "Yellen Sees Risk of Bubbles in Leveraged Loan Market," *Bloomberg News*, July 15, 2014, http://www.bloomberg.com/news/articles/2014-07-15/yellen-sees-risk-of-bubbles-in-leveraged-loan-market.

Trading in the secondary market also continues to perform as well or better, in most key respects, than prior to the crisis.[9] Bid-ask spreads in corporate bond markets are down to around 30 basis points in 2015 for both the most active and less active markets.[10] This is down not only compared to the height of the crisis of 90 basis points, but even compared to the pre-crisis low of 2006, when spreads were approximately 40 basis points for the most active markets and 50 basis points for less active markets.



As of 2015, the price impact of blocks trades, another good measure of trading costs and liquidity, is very similar compared to pre-crisis lows.[11] (See figure below.)

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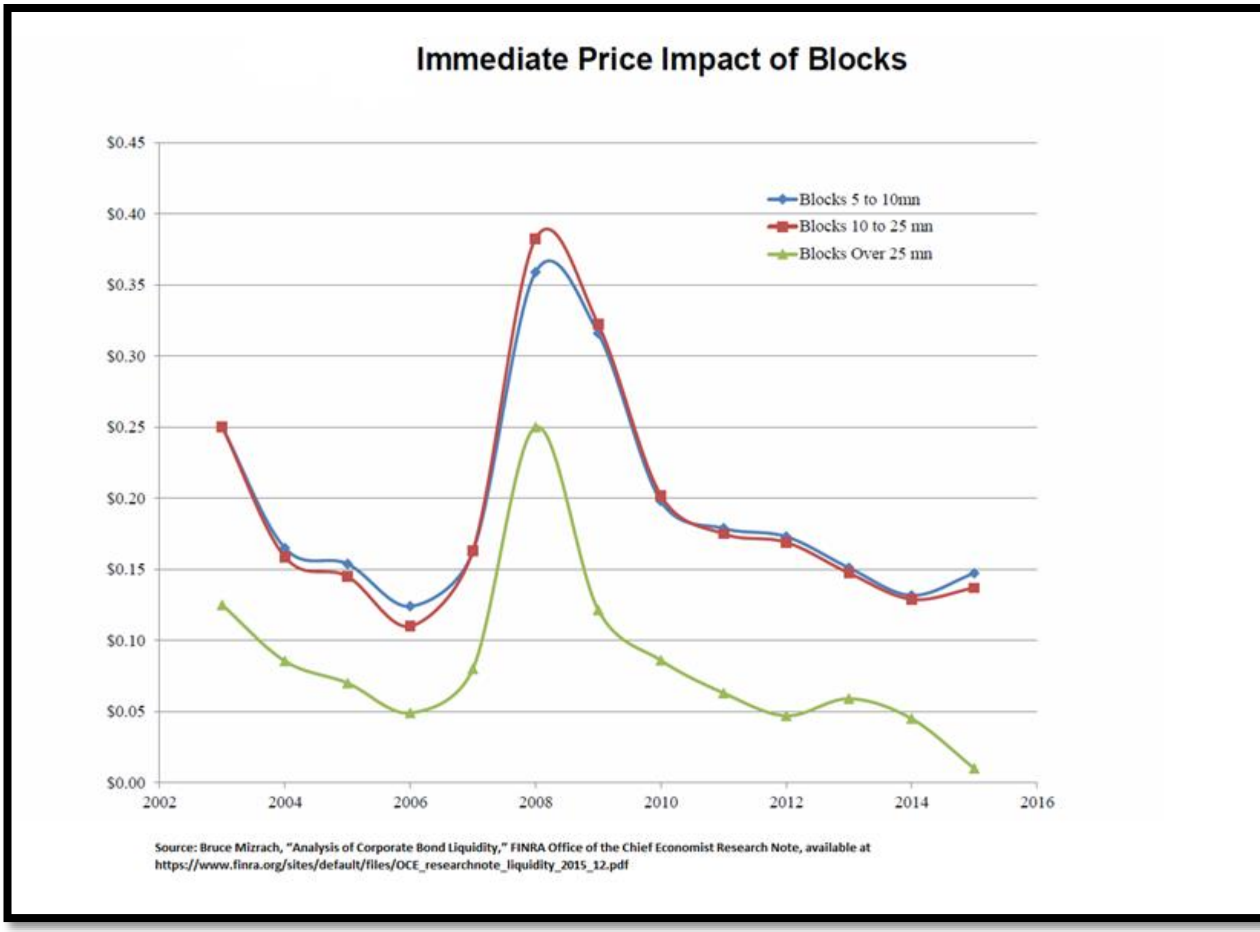
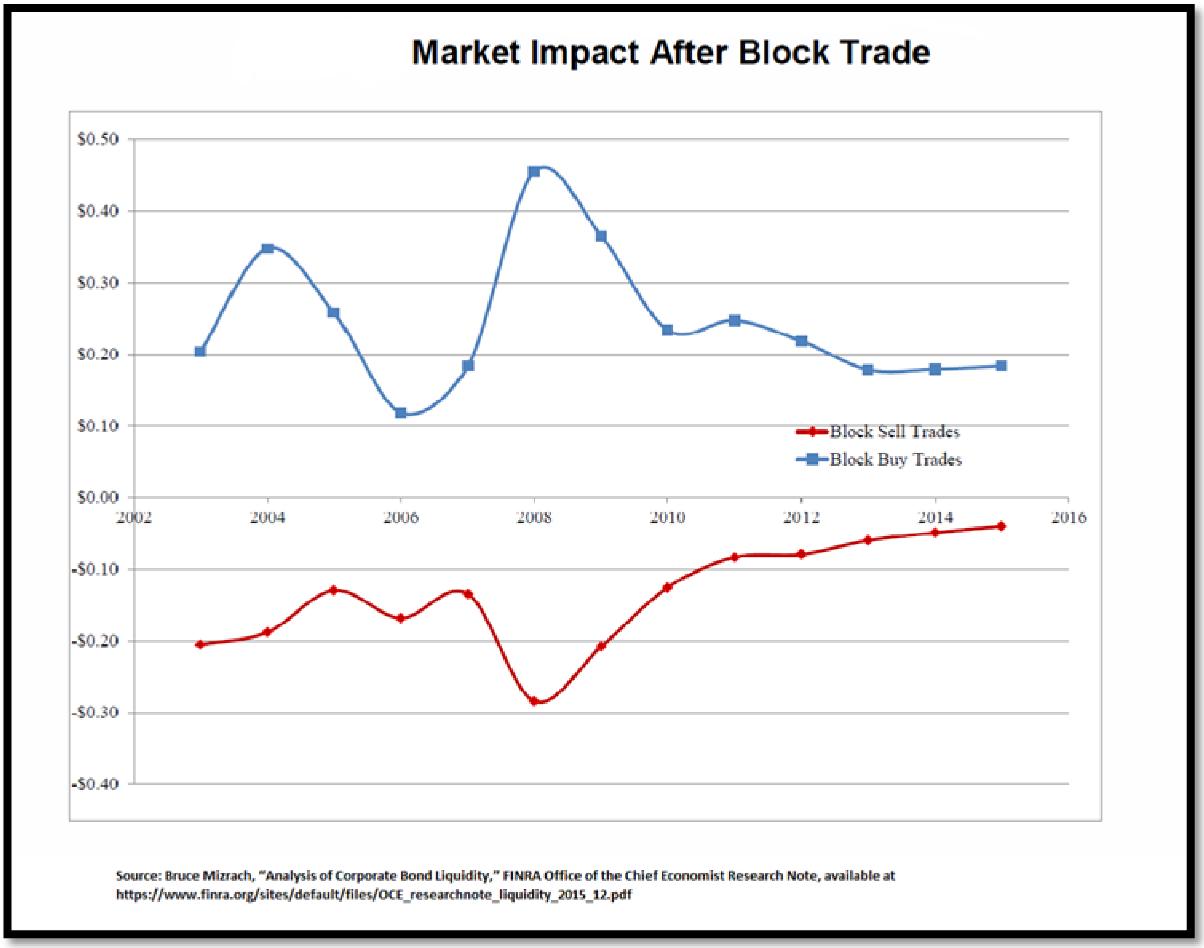
[9] Other new risks may have entered, such as macroeconomic credit risks.
[10] Mizrach, supra, Figure 13.
[11] Mizrach, supra, Figure 14; see also Dudley, supra, Exhibit 8.



Market effects of block trades also appear better than ever. Price changes several trades after the immediate trade are considerably smaller than prior to the crisis.[12] (See figure below.)

[12] Mizrach, supra, Figure 15.



Notably, average trade size is down, from between $700,000 and $800,000 in the early 2000s to about $500,000 more recently.[13] The reason for this is not clear, although it may be related to changing market structure. However, this does not appear to have affected liquidity as measured by indices such as the bid-ask spread.

[13] Dudley, supra.

Notably all measures of trading costs have been coming down since the introduction of TRACE reporting in 2002.[14] To sum up, in the words of New York Fed President William Dudley, "there is limited evidence pointing to a reduction in the average levels of liquidity."[15]

<u>Reforms Counter What Paul Volcker Calls the "Liquidity Illusion"</u>

Yes, dealer inventories of corporate and foreign bonds are down since the crisis.[16] And anecdotally, we have heard that some traders say the markets "feel" different from 2005. This development may, in fact, be a good thing, considering that what followed was a leveraged-fueled bubble that resulted in massive mispricing of assets, incorrect evaluation of liquidity risk, and ultimately the most illiquid markets in decades.[17]

Recently, some have expressed concern regarding what will happen when markets hit the next "air patch."[18] For example, if the Federal Open Markets Committee were to raise interest rates, values of issued fixed rate debt would decline, and investors could wish to sell. If dealers are not able to take large positions, what would happen to the investors who want to sell? The hypothesis is that a liquidity crisis will result and investors will be unable to sell.

But the claim that absent Dodd-Frank and Basel III dealers would prevent or significantly reduce large market movements has little empirical support. First, dealers simply do not "catch the falling knife."[19] Put another way, even if the dealers theoretically could take the other side of a large trade (which they still may be permitted to do under existing rules), the same business

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[14] Mizrach, supra at 12, fn 8, citing to Amy K. Edwards, Lawrence Harris, & Michael S. Piwowar, "Corporate Bond Market Transparency and Transaction Costs," 62 *J. of Fin.* 1421 (2007).
[15] Dudley, supra.
[16] Tracy Alloway, "Digging into dealer inventories," *FT Alphaville*, Sept. 11, 2013, available at http://ftalphaville.ft.com/2013/09/11/1626462/digging-into-dealer-inventories/#.
[17] See Dudley, supra.
[18] Mohamed El-Erian, A New Mindset for a Shifting Global Economy, BloombergView, Jan. 24, 2016, http://www.bloombergview.com/articles/2016-01-24/a-new-mindset-for-a-shifting-global-economy.
[19] See, e.g., Levine, supra.

reasons that other investors want out of the position often make dealers unwilling to take the position. In fact, lower inventory and higher capital may also help dealers step in when it actually makes sense to do so.

The second fallacy of this make-believe liquidity crisis example is that it confuses trading volumes with liquidity. Liquidity is the ability to get into and out of a position quickly and efficiently; it is not the same as guaranteeing a price. Lulled into a sense of complacency by high volumes, market participants may mistakenly believe that they can get out at *any* time, in *any* quantity, under *any* market circumstance. Former Federal Reserve Chairman Paul Volcker calls this the "liquidity illusion." This illusion has several real impacts. Most importantly, we lose the accountability for investment decisions that is so important for the capital markets to efficiently allocate resources to the real economy.[20] Instead, we become at risk of a speculative bubble building and exploding. This is precisely what happened in 2008.

Fortunately, as NY Fed President Dudley and other points out, the changes put in place by the Dodd-Frank Act and consistent with the Basel Committee have made our financial system more stable and resilient, while continuing to enable it to serve the financing needs of the real economy.[21] Risks cannot be as large, funding cannot be as fickle, and losses must be covered by an increased level of shareholder equity. Indeed, some remain concerned that not enough has been done.[22] Ultimately, the aim is for financial markets to absorb the costs they impose on society and ensure their behavior more accurately reflects market signals. If some, despite the

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[20] Yalman Onaran and Dakin Campbell, Did Bank Rules Kill Liquidity? Volcker, Frank Respond, Oct. 20, 2014, http://www.bloomberg.com/news/articles/2014-10-20/did-bank-rules-kill-liquidity-volcker-frank-respond.
[21] Dudley, supra.
[22] See Deborah Petersen, "Anat Admati: Are Banks Safe Now? A scholar and a former regulator both warn that safeguards are lacking to prevent another financial crisis," *Insights by Stanford Business*, May 19, 2015, https://www.gsb.stanford.edu/insights/anat-admati-are-banks-safe-now.

data, still feel that the price of liquidity remains too high, perhaps they have identified a market opportunity: new capital should enter the market and lower the price. That is what it means to have competitive capital markets.[23]

Going Forward, Policymakers Need to Increase Transparency, Finish the Job, and Respond to Evolving Markets

This is not to say that everything is perfect today. The real question is whether the changes to date have done enough. Important areas of the fixed income markets continue to require reform. Below are several areas in need of attention.

<u>Transparency in the Fixed Income Markets Should be Significantly Increased</u>

Transparency has long brought tremendous benefits to the markets and investors. For example, the TRACE reporting system for corporate bonds and securitized products brought costs down dramatically since its introduction in 2002.[24] Forthcoming proposed changes to increase transparency regarding the costs investors pay in these markets have earned bipartisan support.[25] Separately, a Joint Report by the U.S. Treasury Department and other regulators

[23] See Hon. Kara M. Stein, The Volcker Rule: Observations on Systemic Resiliency, Competition, and Implementation, Feb. 9, 2015, https://www.sec.gov/news/speech/volcker-rule-observations-on-systemic-resiliency-competition.html.

[24] See Edwards et al, supra.

[25] See Andrew Ackerman, "New Bond Rules Target Large Broker Fees," *The Wall Street Journal*, Feb. 18, 2016, http://www.wsj.com/articles/new-bond-rules-target-large-broker-fees-1455830010; see, e.g., Hon. Dan Gallagher, "A Watched Pot Never Boils: the Need for SEC Supervision of Fixed Income Liquidity, Market Structure, and Pension Accounting," March 10, 2015, https://www.sec.gov/news/speech/031015-spch-cdmg.html.

called for greater transparency into the market for U.S. Treasury debt.[26] The tri-party and bilateral repo markets are also in need of significantly enhanced transparency.[27]

Academics, regulators, and advocacy groups have specifically called for more transparency regarding the institutions active in the fixed income markets.[28] I join in those calls and urge the Securities and Exchange Commission (SEC) to move faster on reimagining and rewriting its guide to financial sector disclosures. Greater transparency can also be brought to Volcker Rule compliance.

Congress should also be commended for requesting in the recent omnibus appropriations bill that the Securities and Exchange Commission (SEC) study the fixed income markets, including impacts of the Dodd-Frank Act and Basel III. I would urge, however, that such a study include the other independent regulatory and monitoring agencies as well. They have a role in monitoring and overseeing fixed income markets and institutions, and may have important insights to contribute about new and emerging trends.[29] Instilling a culture of cooperation is also

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[26] U.S. Department of the Treasury, et al, *Joint Staff Report: The U.S. Treasury Market on October 15, 2014*, July 13, 2015, https://www.treasury.gov/press-center/press-releases/Documents/Joint_Staff_Report_Treasury_10-15-2015.pdf.
[27] Viktoria Baklanova, Cecilia Caglio, Marco Cipriani, Adam Copeland, The U.S. Bilateral Repo Market: Lessons from a New Survey, Office of Financial Research, Jan. 13, 2016, https://financialresearch.gov/briefs/files/OFRbr-2016-01_US-Bilateral-Repo-Market-Lessons-from-Survey.pdf.
[28] See Henry Hu, Disclosure Universes and Modes of Information: Banks, Innovation, and Divergent Regulatory Quests, 31 Yale J. on Reg. 565 (2014); Hon. Kara M. Stein, Remarks before the Peterson Institute on International Economics, June 12, 2014, https://www.sec.gov/News/Speech/Detail/Speech/1370542076896; Hon. Michael Piwowar, "Remarks before the Exchequer Club," May 20, 2015, https://www.sec.gov/news/speech/remarks-before-exchequer-club-washington-dc.html; Letter to Hon. Thomas Curry, et al, from Americans for Financial Reform, Dec. 17, 2015, http://ourfinancialsecurity.org/2015/12/letter-to-regulators-the-public-deserves-more-transparency-on-volcker-rule-implementation/; Center for American Progress, Report of the Commission on Inclusive Prosperity, Jan. 15, 2015, 91-92, https://cdn.americanprogress.org/wp-content/uploads/2015/01/IPC-PDF-full.pdf.
[29] This might include the interactions between more liquid CDS markets, the growth of ETFs, and the cash bond markets, as well as increased electronic trading in fixed income markets. See "Liquid Leak," *The Economist*, Feb. 20, 2016, http://www.economist.com/news/finance-and-economics/21693245-can-weak-markets-be-explained-changes-bank-balance-sheets-liquid-leak?frsc=dg|c; Liquidnet Launches Fixed Income Dark Pool to Centralize Institutional Trading of Corporate Bonds," September 28, 2015, http://www.liquidnet.com/#/news/liquidnet-launches-fixed-income-dark-pool-to-centralize-institutional-tradi/.

essential for the U.S. to maintain a flexible approach to financial markets and will ensure that the public and their representatives will benefit from more information.

Congress and Regulators Should Be Proud of the Changes Put in Place and Finish the Job

The stronger performance by the U.S. banking sector as compared to the European banking sector highlights the value of the changes the U.S. has put in place, including a stronger leverage ratio, the Volcker Rule, and resolution authorities. European banks remain thinly capitalized and deeply involved in higher risk fixed income trading.[30] European policymakers even moved last summer to weaken the capital treatment of securitizations.[31] Perhaps unsurprisingly, markets are now punishing European bank stocks and their contingent convertible (co-co) debt, a potential reflection of skepticism that remains around European banks' ability to sustain losses and remain solvent.

Fortunately, the Federal Reserve Board has imposed U.S. financial stability requirements on foreign branches and operations in the U.S., allowing us to be moderately less concerned about shocks delivered by their failure. These regulations, under attack by European regulatory and trade negotiators, were sorely needed, as some of the largest foreign banking organizations ran *negative* capital in the U.S. under pre-Dodd-Frank Act regulation.[32] That is, they had more liabilities than they had assets in the U.S. With new regulations in place, firms have had to create intermediate holding companies and meet U.S. capital and liquidity rules. This example

[30] Martin Wolf, "Banks are still the weak links in the economic chain," *Financial Times*, Feb. 16, 2016, http://www.ft.com/intl/cms/s/0/a97efd1e-d34c-11e5-829b-8564e7528e54.html#axzz40psuCjY5.
[31] Boris Groendahl, John Glover and Rebecca Christie, Banks Set for Asset-Backed Debt Relief in EU Overhaul, *Bloomberg News*, Aug. 21, 2015, http://www.bloomberg.com/news/articles/2015-08-20/eu-said-to-seek-lower-capital-charges-for-simple-securitizations.
[32] See Simon Johnson, "Two Steps Forward and One Step Back for the Federal Reserve," Economix Blog, *N.Y. Times*, Feb. 20, 2014, http://economix.blogs.nytimes.com/2014/02/20/two-steps-forward-and-one-step-back-for-the-federal-reserve/?_r=0; Marc Jarsulic and Simon Johnson, How a Big Bank Failure Could Unfold, May 23, 2013, Economix Blog, *N.Y. Times*, http://economix.blogs.nytimes.com/2013/05/23/how-a-big-bank-failure-could-unfold/

reflects the increasing regionalization of the global banking business, which in part reflects the continued reliance on national governments to resolve, or rescue, failed banks. The United States will maintain a global competitive edge in banking for a long time to come.

Regulators must, however, finish the implementation of the Dodd-Frank Act. For example, the movie "The Big Short" reminds us that we still need to implement the provisions of Dodd-Frank Act that ban the conflict-ridden behavior that corrupted our securitization markets. Similarly, I would urge Congress *not* to adopt the bills under consideration today by the Subcommittee. They open up unnecessary and damaging loopholes to common sense principles, such as "skin in the game" risk retention and the Volcker Rule separation between private funds and banking entities. Many of the ideas have already been rejected by the regulators as unwise and unnecessary.

It goes without saying that fully funding regulators and reducing the challenges that regulators face in adopting new rules further facilitates their ability to act protect the American taxpayer. It is also important to remember that as regulations try to accommodate the quirks of particular firms or industries, they become more complex and harder to enforce. Sometimes, compliance is simply the best approach.

Thank you, and I would be happy to answer any questions.