100 Years Standing Up for American Enterprise

U.S. CHAMBER OF COMMERCE

Statement of the U.S. Chamber of Commerce

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

TO: The House Committee on Financial Services

DATE: December 13, 2012

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.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged 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 national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Chairman Bachus, Ranking Member Frank and members of the House Financial Services Committee. My name is Tom Quaadman, Vice President for the Center for Capital Markets Competitiveness at the U.S. Chamber of Commerce. The Chamber is the world's largest business federation representing the interests of more than three million businesses and organizations of every size, sector and region. On behalf of the Chamber's membership, I appreciate the opportunity to testify on the impacts of the Volcker Rule upon markets, businesses, investors and job creation.

America's businesses, in order to compete, grow and create jobs, need efficient capital markets. Efficient capital markets allow businesses to have the access to the resources needed to operate on a daily basis and strategically plan for long-term success. They give businesses large and small the means and confidence to plan, expand and create jobs. Effective regulators who understand these markets allow good actors to play on an even playing field while driving out bad actors and punishing them.

There is a direct link between the strength and resiliency of the American economy and the fact that our capital markets are the deepest, broadest and most resilient in the world.

While the intention of the Volcker Rule is to ban "proprietary trading" by financial institutions, the reality of the Volcker Rule is that it creates an ill-defined and ill-conceived standard that will impair the efficiency of American capital markets in a way that will harm businesses and investors who rely on those markets.

The Chamber supports policies that will improve the efficiency of the capital markets and prevent another financial crisis. We do not believe that the Volcker Rule meets those goals. This is why the Chamber has supported higher capital requirements, instead of a unilateral ban on proprietary trading, as a pro-growth means of stabilizing the financial system.

The Volcker Rule, as proposed, will not promote growth or stabilize the financial system. Indeed it will make U.S. capital markets less robust, U.S. businesses less competitive and ultimately hamper economic growth and the job creation that accompanies it. The lack of clarity in the proposed regulatory provisions and the vagueness of the term "proprietary trading" itself will cause financial institutions to scale back and even cease to offer some critical services they provide, reducing capital formation for non-financial businesses.

Mr. Chairman, the Chamber is very appreciative of the letter that you and Representative Hensarling sent requesting a further delay in the completion of the

Volcker Rule. The Chamber also supports the introduction of H.R. 6524. This bill was introduced by Rep. Peter King, to stay enforcement of the Volcker Rule until other nations adopt similar restrictions. These efforts are important steps to preserve American competitiveness.

Cumulative Impacts of the Volcker Rule and other Regulatory Initiatives

The Volcker Rule cannot be viewed in a vacuum and must be examined in light of other major financial regulatory initiatives including potential new money market fund regulations, derivatives regulations and Basel III capital standards. Each has been proposed to address a perceived need to change a different segment of the financial system.

However, each of these regulatory initiatives has unique and collective impacts upon the ability of a corporate treasurer to make sure that a business has the cash to pay the bills and grow:

- The Volcker Rule impacts the ability of businesses to access the debt and equity markets.
- New money market proposals affect the capacity of a business to sell commercial paper and use efficient cash management techniques.
- Derivatives regulations shape the ability of businesses to manage risk and lock in prices for raw materials.
- Basel III impinges on the ability of businesses to access commercial lines of credit and obtain bank loans.

Each will impact treasury operations of American businesses and the cumulative impact of these efforts could be devastating.

Companies doing business in the U.S. operate with approximately $2 trillion of cash reserves, which is a historically high number. That number represents 14% of U.S. gross domestic product, but in contrast, corporate cash reserves in the Euro zone is 21% of Euro zone GDP.

Highly liquid capital markets in the United States permit treasurers to keep less cash on hand and use a "just-in-time" financing system that allows companies to meet working capital needs and raise additional capital needed to expand and create jobs.

Should the Volcker Rule be enacted in its present form, capital efficiency will decline, resulting in the need to maintain increased corporate cash buffers. Were idle cash reserves to rise to the Euro zone level of 21% of GDP, that new level would be $3 trillion. Higher cash reserves would not be an historic outlier; it will be the new normal.

Stated differently, corporate Treasurers would need to set aside and idle an additional $1 trillion of cash. 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 if U.S. companies had to withdraw from productive use funding that dwarfs the stimulus bill.

Specific Concerns with the Volcker Rule

The ambiguity surrounding provisions of the Volcker Rule is likely to have a chilling effect on precisely those banking services that account for U.S. competitiveness, capital efficiency and financial stability. This is an issue for U.S. businesses, large and small.

Some of the unintended consequences of the Volcker Rule include:

- 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
- Prohibitions on traditional investments mislabeled as “funds”
- Increased compliance costs for **non-financial** businesses
- Higher bank fees for consumers and businesses
- Less access to capital for small business and start ups

- Shifting of risks to other sectors of the economy
- Capital flows into offshore markets
- Potential Trade Violations
- Extension to joint ventures

a. <u>Impaired market liquidity and reduced access to credit</u>

The Volcker Rule may impair the ability of banks to function as market makers. Banks act as significant buyers and sellers of securities to ensure that borrowers can find investors and investors can find investments.

As market makers, banks hold inventory. This could be inventory in various investment instruments, Treasury debt, customer securities and foreign currencies. However, the Volcker Rule will significantly constrain market making by dictating how banks should manage their inventory. This will reduce the depth and liquidity of our capital markets.

For example, corporations, municipalities, healthcare providers and universities rely upon the "market making" activities of bank in order to secure affordable funding in the bond market. Bank trading activities are what create market liquidity and enable the market to provide an efficient clearing price. Thus, if banks can no longer hold inventory, it will be much more difficult for businesses, municipalities and schools to raise capital.

Without these activities, markets could take a giant step backward. Many American businesses will have to rely solely on commercial loans. This will increase their financing costs and force them to hold greater idle cash reserves.

b. <u>Higher costs and less certainty for borrowers</u>

The Volcker Rule will increase the cost of capital for all companies. With reduced market liquidity, transaction spreads widen, risks increase and price changes become more volatile. To compensate for these new risks, investors will demand higher rates.

Because banks can currently underwrite a bond issue for a customer and hold any unsold bonds in inventory, credit worthy borrowers can be reasonably assured of timely access to credit. However, under the Volcker Rule in its current form, banks may not be able to hold that inventory. They therefore, may decide to defer or delay underwriting those bonds for their customers until buyers are found in advance.

Imagine a municipality or a hospital facing a critical funding need. Under the Volcker rule, they may go bankrupt waiting for a bank to line up the funding. Or, they would end up paying a crippling rate.

c. <u>Restricted trading in proper and allowable businesses</u>

The Proposed Rule is inherently complicated and forces regulators to discern the intent of a trade. Worse, they require banks to "prove" the intent of each trade. This cannot be done in any reliable and consistent way. One entity's proprietary trade is another entity's market making activity—the trades may look no different on paper. 'Proprietary trading' defies a symmetrical definition.

The complexity and vagueness of the Volcker Rule will force banks to adopt the most conservative interpretation of the rule and err on the side of prohibiting certain trades that have no proprietary "intent". With the burden of proof on the banks, the compliance costs become prohibitive. The net result will likely be the elimination of perfectly acceptable "market making' activities. This could result in banks exiting or scaling back such routine activities as commercial paper issuance, cash management sweep accounts and multi-currency trade finance.

d. <u>Competitive disadvantage for U.S. businesses and financial institutions</u>

The United States' major trading partners have rejected the Obama Administration's request to follow the Volcker Rule. This puts American businesses and financial institutions at a disadvantage. By eliminating a core revenue stream from U.S. banks, the Volcker Rule would effectively reduce the ability for U.S. banks to compete and continue to provide services that are essential to our nation's businesses. Additionally, in order to avoid the territorial jurisdiction of the Volcker Rule, foreign financial firms may retreat from the U.S., further depriving American businesses of capital and degrading the ability of U.S. regulators to oversee and regulate financial activity.

Finally, most companies will still have financial risks that need to be managed. U.S. business will increasingly turn to foreign banks in overseas markets to serve this function. Perversely, this will simultaneously weaken U.S. banks while strengthening foreign banks.

e. Prohibitions on traditional investments mislabeled as "funds"

There has been wide recognition by the Financial Stability Oversight Council and industry members that the Volcker Rule's definitions of private equity funds and hedge funds are extremely overbroad, and could result in unintended prohibitions of legitimate and useful activities and investments. Unless corrected through regulation or legislation, this over-breadth could prohibit securitization vehicles, cash management entities, certain joint ventures and even internal holding companies simply because they meet a technical legal standard that is common among true investment funds.

Prohibiting these investments would severely disrupt all businesses affected by the Volcker Rule, and would have ripple effects throughout the real economy as legitimate business activities such as securitization, cash management and joint venture business partnerships are disrupted.

f. Increased compliance costs for *non-financial* businesses

The reach of the Volcker Rule can extend to non-financial businesses, although they present no systemic risk whatsoever. Many businesses offer financing services to their customers to accommodate their commercial relationship. They may own a depository institution, have a commercial or consumer finance subsidiary or sponsor a credit card. These businesses will incur increased costs and higher compliance burdens. Some will pass these costs on to their customers. Others will simply discontinue these financial services. In any event, the result is higher cost credit for those willing to pay and less credit for most small businesses and consumers.

g. Higher bank fees for consumers and businesses

The cumulative effect of regulatory changes such as the Volcker Rule, and Basel III will be to reduce or eliminate core banking revenue. At the same time, the Volcker rule will materially increase the costs of regulatory compliance. In order to continue providing high quality technologically advanced banking services, U.S. banks will need to increase banking fees on a wide range of services. They may also need to become more selective in the customer segments they choose to serve, thereby reducing the general availability of banking services.

h. Less access to capital for small business and start ups

As banks restrict the availability of their services and increase the price, an inevitable "crowding out" will occur. The largest corporations and those who transact in the highest denominations will still have access to credit and risk management products. However, the less credit worthy customers and start-ups will be left out. Many traditional services will be no longer cost effective. Some may not be available to those segments at all.

i. Shifting of risks to other sectors of the economy

In the dynamic world of free enterprise, risk is neither created nor destroyed. It can only be transformed. A corporate CFO whose company imports a raw material from the Far East, for example, must manage currency risk, commodity price risk, interest rate risk and operational shipping risks. Simply precluding a bank from helping the company hedge those risks, the Volcker Rule does not make those risks go away.

CFOs and Treasurers will undoubtedly conclude that some risk management techniques and some heretofore efficient transactions will no longer be cost effective. They will decide to "go naked" and retain that risk internally. The upshot of this is that they will hold even more precautionary cash on their balance sheets as a buffer. This will take money out of the real economy.

j. Capital flows into offshore markets

Corporate treasury is the financial nerve center of a company, daily facing and managing the complexities of the global markets. Most treasurers select a lead bank as their primary source of capital, information and advice. That bank must be one that cannot only give the company global visibility, but can seamlessly operate in markets far and wide. The Volcker Rule would virtually eliminate U.S. banks from contention for that important 'lead' role.

Many U.S. multinational companies are already selecting lead banks for each region of the globe, eroding the dominance of the U.S. banks. Many companies are establishing regional treasury centers for functions traditionally housed in the U.S. All of this leads to capital flowing out of the U.S. and competitiveness declining.

k. Potential Trade Violations

Many nations including Canada, Japan, the United Kingdom, and Singapore have objected to the Volcker Rule, citing adverse consequences to *their* ability to issue sovereign debt. The Volcker Rule is discriminatory, as foreign sovereign debt is subject to the regulation, while U.S. Treasury debt instruments are exempt. This creates a discord in the G20 and invites foreign governments to retaliate at a time when we need those same regulators in foreign countries to support initiatives to liberalize trade in financial services. The Chamber has called for the U.S. Trade Representative ("USTR") to conduct a very close examination to ensure the Volcker Rule does not violate any of our trade obligations. Ultimately it may not, but the Volcker Rule's discriminatory provision certainly does, at a minimum, send the wrong message internationally and gravely complicates the long-standing U.S. goal of liberalizing trade in financial services in addition to creating a potential problem for U.S. sovereign debt if foreign governments decide to retaliate.

The Chamber believes it is important that USTR evaluate the Volcker Rule in the context of our trade commitments and be an active voice in the inter-agency process so that regulators understand the costs to the American economy and potential retaliatory actions the United States faces if other nations treat the Volcker Rule as a trade violation or choose to adopt similar restrictions on U.S. sovereign debt.

l. <u>Extension to Joint Ventures</u>

Joint Ventures are a means of companies and entities to band together and equally develop new business lines or assets. This is an important vehicle for companies to remain competitive, particularly overseas where partnership with a local business may be necessary to enter the market. Under the Volcker Rule, if an entity involved in a Joint Venture is deemed to be part of a "banking entity" and required to have a Volcker Rule compliance program, then the Joint Venture itself would also be required to have a Volcker Rule compliance program and face all of the associated activity limitations under the Rule. This is an illogical overextension of the Volcker Rule. Subjecting Joint Ventures to Volcker Rule prohibitions and compliance programs will increase regulatory complexity for Joint Ventures and place American companies at a competitive disadvantage as compared to their foreign counterparts.

Process Concerns with the Volcker Rule

The Volcker Rule, first proposed in 2011, encompasses 298 pages and asks over 1,000 questions. This is an extremely complex regulation that could lead to oversight of the issuance and trading of bonds and stocks on an unprecedented scale. News reports have indicated that 1) regulators are reluctant to re-propose the rule and 2) that the Securities and Exchange Commission and banking regulators may have some significant differences.

We are troubled that there may not be a re-proposal of the Volcker Rule. This will deprive stakeholders of an opportunity to review the final rule and compare it to the proposed rule. Informed commentary of a re-proposal will give regulators important feedback to avoid unintended adverse consequences before the Volcker Rule is finalized. We believe that regulators may be missing an important opportunity to fix a flawed proposal.

The Chamber is also concerned that the Volcker Rule has a fractured, incomplete and uncoordinated study of the economic impacts and costs and benefits associated with the proposed rule. Thus, stakeholders were not provided an analysis of the costs and benefits associated with the proposed rule to provide regulators with informed commentary.

The Volcker Rule Proposal must follow the requirements of the Administrative Procedures Act ("APA"). Additionally, the Federal Reserve, FDIC, OCC, SEC ,and CFTC each have differing legal standards and internal practices they must meet for economic analysis when promulgating a rule. There is a real question as to whether many of these agencies have satisfied these obligations as to the proposed Volcker Rule. Given this haphazard and uncoordinated analysis under existing practices, the Chamber a year ago proposed that all of the agencies involved in the Volcker Rule Proposal establish a common baseline for cost-benefit and economic analysis by using the blueprint established by Executive Orders 13563 and 13579, in addition to other requirements they must follow.[1] This would allow meaningful, cumulative analysis that would result in a more coherent final rule with fewer harmful, unintended consequences for America's capital markets.

Last year, the Chamber provided the regulators with examples of the significant costs to non-financial companies that we believe were not contemplated in the initial Volcker Rule release. The Chamber conducted a survey that uses 2010-2011 historic data of select U.S. financing companies that service non-financial businesses. Based on credible assessments that the Volcker Rule will impose a 5 basis point increase in bid-ask spreads, for just the 5 companies selected, the increased lending costs total nearly $150 million for just those companies. The survey also includes an analysis of switching transactions—the process whereby a financial institution buys back some of an issuer's older bonds as part of the process for a new issuance. A 10 basis point increase caused by the Volcker Rule would increase the costs of switching

[1] Executive Order 13579 requests that independent agencies follow the requirements of Executive Order 13563. Both executive orders were issued by President Barack Obama.

transactions by $2.8 million per billion issued while a 50 basis point increase would drive up costs by nearly $14 million per billion issued.

Because there is ample reason to believe that the costs that would be imposed by the proposed Volcker Rule to the economy, state and local governments are well over $100 million, the OCC should submit the proposed rule to an Office of Information and Regulatory Affairs ("OIRA") regulatory review process. The Federal Reserve, FDIC, SEC and CFTC should also voluntarily submit their portions of the Volcker Rule Proposal for an OIRA regulatory review process to ensure consistent and uniform analysis.

Conclusion

The Chamber continues to have serious concerns that the Volcker Rule, as currently constructed, will not reduce systemic risk nor improve economic well-being. We believe that it will make U.S. capital markets less robust, U.S. business less competitive and ultimately reduce underlying economic activity and the job creation that accompanies it. We believe that the lack of clarity in the proposed rule and definition of "propriety" trading itself will cause financial institutions to scale back and even exit some of the critical services they provide.

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