

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.

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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>