

Douglas J. Elliott

Thank you for the opportunity to testify today on the Volcker Rule. I should note that while I am a Fellow at the Brookings Institution, my testimony today is solely on my own behalf, as Brookings does not normally take policy positions as an institution.

As I will explain, I believe that the Volcker Rule is fundamentally flawed and will do considerably more harm than good for the economy. I base this on two decades on Wall Street as well as on the years I have spent examining federal policy towards financial institutions at Brookings and earlier at another think tank. Despite being a former banker, my views on the Volcker Rule do not stem from opposition to the Dodd-Frank reforms. Indeed, I am on record as a strong supporter of the overall approach of that legislation, although there are certainly things I would have preferred to see done differently.

My core problem with the Volcker Rule is that it seems to me to be trying to eliminate excessive investment risk at our core financial institutions without measuring either the level of investment risk or the capacity of the institutions to handle the risk, which would tell us whether the risk was excessive. Instead, the rule focuses on the intent of the investment rather than its risk characteristics.

This approach creates at least four conceptual problems. First, there is the question of relevance. It is unclear to me why I care very much what the intent of the bank was. It's the level of risk relative to the capacity to bear that risk which is of prime interest. The globally-agreed Basel rules on bank capital take a more intelligent approach, by explicitly measuring both investment risk and the adequacy of capital to absorb those risks. One can validly argue about the techniques used to do this, but it makes a lot more sense to fix any flaws in that approach than to act as if we have no ability to measure risk or capital. If you are dubious about the technical measurements, then add further safety margins, but retain the focus on the key attributes of *risk* and the *ability to bear risk*.

Second, the concept of "proprietary investments" is a very subjective and arbitrary one. Many supporters of the rule seem to be particularly concerned about investments made by banks which are funded with depositor money and on which the shareholders collect any gain. However, this set of criteria captures essentially any investment made by a bank, since depositor funds are basically interchangeable with all the other funds gathered by a bank and the shareholders always benefit from any gains on investments. I surmise that the underlying rationale for the rule is to try to separate out activities that are integral to banking from those that are not. By focusing on investments alone, the Volcker Rule implicitly assumes that lending is good. In addition, some investment activities are recognized as integral to banking, while others are not.

This raises several concerns for me. First, I do not always agree with the arbitrary choices about what is integral and what is not. For example, I believe that the Volcker Rule is much too onerous in its restrictions on the roles that banks are allowed to play with hedge funds and private equity funds, which are now core parts of the investment management business, which has long been a key banking function. Second, it is often extremely hard to draw the line between acceptable and unacceptable

activities. For instance, securities dealing requires the holding of securities to meet potential customer demand in a timely manner. At what point does the inventory shift from being an appropriate size to being at a level which indicates speculation of a type the Volcker Rule is trying to stop?

Perhaps more fundamentally, finance has evolved over the last few decades to the point where corporate borrowers switch easily between borrowing via loans and via securities. This means that securities activities are now integral to modern banking, just as lending has always been. Even the distinction between a loan and a security is far less clear than it was originally. Advances in information technology and communications mean that it is relatively simple to take a transaction which involves extending credit and to structure it as a loan, if that is advantageous, or as a security, if that would be better for the lender. Large loans are not only syndicated among many banks, but are actively traded among banks and sold to non-bank buyers as well. Thus, the implicit assumption of the Volcker Rule that investments are substantially less integral to banking than lending is misplaced.

Third, operationalizing the arbitrary and subjective distinctions created by the Volcker Rule forces regulators to peer into the hearts of bankers, which will prove to be extremely difficult, if not impossible. This explains why the proposed rules are inevitably so complex, as regulators make an honest effort to obtain enough information to guess the intent behind investment actions. We are in danger of forcing regulators to micromanage the actions banks take in one of their core activities, the ownership and trading of securities. There is no reason to believe that regulators will be better at this than bankers, even recognizing the mistakes made by bankers in the run-up to the financial crisis.

Fourth, by focusing on intent, we are almost certain to miss large swathes of investments that are taken on with an acceptable intent, but still represent excessive risk. This is not a purely theoretical argument, as I can show with an example. As a public policy matter, we want banks, even small ones, to hold substantial portfolios of safe and highly liquid securities so that they can meet sudden demands for cash without having to make a fire sale of their loans or other assets. Much, if not all, of this portfolio will be funded with depositor money and the gains and losses will accrue to shareholders, so it is difficult to distinguish from other “proprietary” investments. Therefore, we clearly have to provide an exemption in order to ensure banks are allowed to hold enough securities for this purpose and the proposed rules do provide such an exemption. But, this brings its own major problem. A large portion of the investment losses at commercial banks in the crisis were on their holdings of securities purchased for liquidity purposes. They bought mortgage-backed and asset-backed securities that were rated “AAA” and which were quite liquid until the financial crisis struck and rendered them illiquid. Thus, the intent would have been considered acceptable, but it did not prevent bankers from weakening their institutions by losing large sums of money.

These four sets of flaws lead me to believe that the Volcker Rule will do a poor job of identifying or eliminating excessive investment risk, will be costly even when it correctly identifies risk, and will be even more costly when it discourages risk that is incorrectly treated as if it were excessive.

The Volcker Rule will raise the cost of credit to our suffering economy by harming our securities markets and by increasing the costs for banks and decreasing their revenues, which will push them to find other ways to pass costs along to their customers. Securities markets will be harmed by a substantial reduction in the liquidity that is currently provided by banks. This will force a widening of bid/ask spreads, equivalent to increasing commissions charged to investors, and will also make new issuances of securities more expensive. Meanwhile, banks will have a reduced role in profitable lines of business that are integral to modern banking, forcing them to find other ways to increase their revenues or reduce their costs. In the end, customers bear the brunt of such efforts.

All of this will translate into a higher cost of funds for companies wishing to invest in new plants or R&D or to hire additional workers. The decreased efficiency of markets would also spur investors to demand higher risk premiums, which should reduce the value of existing stocks, bonds, and other assets, potentially including housing.

There will also be an effect on the international competitiveness of our banks, since they will be more burdened by these restrictions than their global competitors. Globally mobile finance activities will be more likely to take place outside the US than would be the case without this rule. This would further reduce US bank profits, leading to the pass-through to customers of more costs, and would destroy some high-paid US jobs.

I do not wish to exaggerate the effects of the Volcker Rule. We will survive its implementation, but I view it as an unnecessary, self-inflicted wound. Ideally, I would like to see Congress repeal the rule. Failing that, it would be helpful for Congress to send a clear signal that regulators are to implement the rule in a modest fashion that focuses on stopping only those activities that very clearly violate the Volcker Rule without halting activities where the intent of the transactions is unclear. Along with this, regulators should be encouraged to implement the rule in the least burdensome manner possible. That said, the arbitrariness of this rule and the ambiguity of definitions means that there will necessarily be excessive complexity in the regulations.

Thank you again for the opportunity to testify today. I look forward to your questions.

United States House of Representatives
Committee on Financial Services

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3. Business Address and telephone number: <div style="background-color: black; height: 40px; width: 100%;"></div>	
4. Have <u>you</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	5. Have any of the <u>organizations you are representing</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
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7. Signature: <i>Douglas J. Elliott</i>	

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