Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation

Treasury Strategies' Testimony to Congress

U.S. House Subcommittee on Capital Markets and Government Sponsored Enterprises
U.S. House Subcommittee on Financial Institutions & Consumer Credit

January 18, 2012

Treasury Strategies, Inc. was invited to testify at the Congressional hearing "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation" by Chairmen Garrett and Capito, Ranking Members Waters and Maloney, and members of the subcommittees. This was a timely hearing, going to the heart of the stability of the financial system. Anthony J. Carfang, a founding partner, represented and served as spokesperson for the firm, and also for the U.S. Chamber of Commerce.

Introduction

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 consulted to many of the world's largest and most complex corporations and financial institutions.

The purpose of the testimony was, on behalf of the U.S. Chamber of Commerce, to discuss the impact of the Volcker Rule on non-financial businesses.

The questions that have not been asked and that need to be answered by both the regulators and Congress are simply these: How does the Volcker Rule impact the ability of non-financial companies to raise capital and mitigate risk, and are we willing to live with the adverse impacts of the Volcker Rule that will affect the competitiveness and the overall efficiency of the U.S. economy?

Treasury Strategies and our clients fully support well-thought-out efforts to improve economic efficiency and to reduce the likelihood of another systemic failure. The U.S. Chamber's position is the same and they have advocated for stronger capital rules, rather than a unilateral ban on proprietary trading, as a pro-growth means of stabilizing the financial system and avoiding systemic failure.

However, collectively, we feel strongly that the Volcker Rule, as currently constructed, will not succeed in this effort. We believe that it will make U.S. capital markets less robust, U.S. Businesses less competitive, and ultimately reduce underlying economic activity. We believe that the lack of clarity in many of the proposed regulatory provisions and the lack of a precise definition of "propriety" trading itself will cause financial institutions to scale back and even exit some of the critical services they provide. Simply put, after the Volcker Rule goes into effect, when a business' treasurer calls a bank to raise the cash needed to pay the bills, will someone answer that phone call?

Besides reduced financing for American businesses, the Volcker Rule could actually ***increase*** systemic risk by consolidating assets into the banking system, exacerbating too-big-to-fail.

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Summary

Businesses operating in the U.S. are the most capital-efficient and productive in the world. Thanks to our financial institutions and existing banking frameworks, businesses and the U.S. economy benefit greatly from:

- Broadest, deepest and most resilient capital markets
- Best risk management products and tools
- Most robust liquidity markets
- Technologically-advanced cash management services
- Most efficient and transparent payment systems

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 14%*

of U.S. gross domestic product. In contrast, corporate cash in the Eurozone is 21% of Eurozone GDP. In the UK, the ratio is even higher.

Highly liquid means of raising capital allow treasurers to keep less cash on hand and use a just-in-time financing system that enables companies to pay the bills and raise the capital needed to expand and create jobs.

Should the Volcker Rule be enacted in its present form, capital efficiency will decline, resulting in increased corporate cash buffers. Were cash to rise to the Eurozone level of 21% of GDP, that new level would be $3 trillion.

Stated differently, CFOs and treasurers 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.

Setting so much cash idle 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.

Why would treasurers have to idle so much more cash?

The Volcker Rule, as currently proposed, will increase administrative expenses for banks, and create a subjective regulatory scrutiny of trades, making a company's ability to raise capital more expensive and time consuming. These changes will raise costs for some companies, make foreign capital markets more attractive for some and will shut some companies out of debt markets entirely.

None of these things are happening in a vacuum.

Corporate treasurers must also contend with looming money market regulations that may imperil 40% of the commercial paper market, Basel III lending requirements and expected derivatives regulations.

All of these efforts are converging in one place – the corporate treasury. The combined impacts of these measures have not been thought through.

> "…Risk can neither be created nor destroyed, but only transformed. …When you consider ways to reduce banking system risk, do not be tricked into thinking that risk disappears. It simply moves elsewhere. "

A common understanding among clients regarding financial risk is that, like energy, risk can neither be created nor destroyed, but only transformed. Therefore, when you consider ways to reduce banking system risk, do not be tricked into thinking that risk disappears. It simply moves elsewhere.

To truly minimize the probability of future financial crises, we must understand how this risk transforms and where it will show up next. Risk is managed most efficiently when it is transparent, properly understood and the market responds with robust, efficient and liquid hedging solutions

Specific Unintended Consequences of 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 issue is a concern for U.S. businesses, large and small.

Some of the unintended consequences, in addition to a general slowdown in economic activity, 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
- 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

Let's examine these consequences one by one.

Impaired market liquidity and reduced access to credit

The Volcker Rule will 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 inventory could be in various investment instruments, treasury debt, customer securities and foreign currencies. However, the Volcker Rule significantly constrains their ability by dictating how banks should manage their inventory, which 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 banks in order to secure affordable funding in the bond market. Without these "market making" activities, banks would be unable or unwilling to underwrite these public and private bonds. Thus, if banks can no longer hold inventory, it will be much more difficult for businesses, municipalities and schools to raise capital.

Bank trading activities are what create market liquidity and enable the market to provide an efficient clearing price. Without these activities, markets take a giant step backward to bilateral "deals" and, in effect, a barter or auction system.

Higher costs and less certainty for borrowers

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, creditworthy 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 instead 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 would go bankrupt while waiting for a bank to line up the funding. Or, they would end up paying a crippling rate.

Restricted trading in proper and allowable businesses

The proposed rule is inherently complicated and forces regulators to define the intent of a trade. Worse, they require banks to "prove" the intent of each trade. This proof cannot be done in any reliable and consistent way. One entity's proprietary trade is another entity's "market making" activity. "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 the least favorable "intent" of any trade. 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. Eliminating these activities could result in banks exiting or scaling back such routine activities as commercial paper issuance, cash management sweep accounts and multi-currency trade finance. These are services which all Treasury Strategies clients view as critical solutions to execute sound financial management.

Competitive disadvantage for U.S. businesses and financial institutions

The United States' major trading partners have rejected the Obama Administration's request to follow the Volcker rule. This rejection 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 grow. 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.

> "U.S. Businesses will increasingly turn to foreign banks in overseas markets – which would simultaneously weaken U.S. banks while strengthening foreign banks. "

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 – which would simultaneously weaken U.S. banks while strengthening foreign banks.

*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. They may own a bank, have a commercial or consumer finance subsidiary or have a credit card company. These businesses will incur increased costs and higher compliance burdens. Some will pass these costs on to their customers. Others will simply discontinue the financial or card services. In any event, the result is higher-cost credit for those willing to pay and less credit for most small businesses and consumers.

Higher bank fees for consumers and businesses

The cumulative effect of regulatory changes such as the Volcker Rule and Basel III will 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.

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 very highestrated corporations and those who transact in the highest denominations will still have access to credit and risk management products. However, the less creditworthy 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.

Shifting of risks to other sectors of the economy

As stated earlier, 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 risk. Simply precluding a bank from helping the company hedge those risks, the Volcker Rule does not make those risks go away. Indeed, the risk becomes less transparent and thus more potent.

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

Capital flows into offshore markets

Corporate treasury is the financial nerve center of the firm, 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 companies have recently engaged Treasury Strategies to assist in upgrading their treasury technology. Their intent is to get a real-time view of their cash, and implement automated tools to easily move that cash around the globe. In this frictionless environment, cash can easily be moved to the most favorable jurisdictions.

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. This regional structuring leads to capital flowing out of the U.S. and competitiveness declining.

Process Issues

Now that we have discussed the impacts of the Volcker Rule upon non-financial companies, let us consider regulatory process issues that make it extremely difficult, if not impossible, for businesses to understand how the Volcker Rule will impact their ability to raise capital.

The Federal Reserve (“Fed”), Federal Deposit Insurance Corporation (“FDIC”), Office of the Comptroller of the Currency (“OCC”) and Securities and Exchange Commission (“SEC”) proposed their portion of the Volcker Rule implementing regulations in October, and these were published in the Federal Register on November 7, 2011. The Commodities and Futures Trading Commission (“CFTC”) voted on its proposal last week, but has not yet published its proposal in the Federal Register.

Each of these regulators looks at a separate portion of the markets, so it is only possible to understand the full scope and impacts of the proposed regulations when one examines the interrelationships of the proposed rules and the markets themselves. While the CFTC is expected to close its comment period 60 days after publication in the Federal Register, the other regulators’ comment period will close on February 13, 2012.

It is impossible to conduct a thoughtful analysis and provide regulators with informed answers to the over 1,000 questions they have asked. Accordingly, in terms of fundamental fairness, the comment periods should be reconciled and extended for all of the regulators.

Conclusion

On behalf of the U.S. Chamber of Commerce and Treasury Strategies, Inc., we feel strongly 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. Businesses less competitive, and ultimately reduce underlying economic activity. We believe that the lack of clarity in many of the bill's provisions and the lack of a precise definition of "propriety" trading itself will cause financial institutions to scale back and even exit some of the critical services they provide. Finally, we are deeply concerned that the Volcker Rule will increase concentration of assets into the banking system and actually increase systemic risk.

We welcome any questions you may have. Please visit TreasuryStrategies.com for details and information about Treasury Strategies.

You may also watch a video of our opening comments, which are the first six minutes of the clip.

About Treasury Strategies, Inc.
Treasury Strategies, Inc. is the leading Treasury consulting firm working with corporations and financial services providers. Our experience and thought leadership in treasury management, working capital management, liquidity and payments, combined with our comprehensive view of the market, rewards you with a unique perspective, unparalleled insights and actionable solutions.
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