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

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Marc Jarsulic
Vice President, Economic Policy
Center for American Progress

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Thank you, Chairman Huizenga and Ranking Member Maloney, for the opportunity to testify on this important topic. I am the Vice President for Economic Policy at the Center for American Progress, where I lead our Economic Policy team. Today, I will attempt to outline the importance of the Volcker Rule and to highlight the evidence that the Volcker Rule has not caused a deterioration of liquidity in the corporate bond market.

The Purpose of the Volcker Rule

The Volcker Rule is intended to do something very reasonable – to prevent Bank Holding Companies and subsidiaries from engaging in proprietary trading and speculative hedge fund and private equity investments. These activities are capable of quickly generating high levels of risk and large losses, which can damage the balance sheets of even very large banks.

The losses by JPMorgan Chase in the 2012 "London Whale" incident – which involved proprietary-trading type activities are illustrative of the risks that can be generated. In that incident, a single trader, who was managing part of the bank's synthetic credit portfolio in London, took such large positions in credit derivatives that other market participants began to refer to him as the Whale. Losses mounted, and when the positions were finally unwound, the bank was out $6 billion. At the time the Volcker Rule was set to be finalized in late

2013, Treasury Secretary Jack Lew explicitly stated that the final rule was intended to prevent London Whale-style bets.[1]

During the financial crisis, large losses were sustained by many large banks around the world because of failed trading strategies. In 2009 the Basel Committee on Banking Supervision noted that "[s]ince the financial crisis began in mid-2007, the majority of losses and most of the build-up of leverage occurred in the trading book. Losses in many banks' trading books during the financial crisis have been significantly higher than the minimum capital requirements under the Pillar 1 market risk rules."[2]

We also know from historical experience that when many important financial institutions engage in excessive risk taking, taxpayers can be left bearing the burden when their bets go bad. During the financial crisis, large amounts of risk were shifted onto U.S. taxpayers as the risks taken by the large Bank Holding Companies and other important financial market actors generated substantial losses. Because those losses threatened asset fire sales and widespread panic, the Federal Reserve, FDIC and Treasury were forced to step in to support asset prices and the institutions that were threatened with ruinous losses. Trillions of dollars of taxpayer

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[1] Ian Katz and Kasia Klimasinska, "Lew Says Volcker Rule to Prevent Repeat of London Whale Bets," Bloomberg, December 5, 2013, available at https://www.bloomberg.com/news/articles/2013-12-05/lew-says-volcker-rule-meets-obama-s-goals-in-financial-oversight.

[2] Joint FSF-BCBS Working Group on Bank Capital Issues (2009). Reducing procyclicality arising from the bank capital framework, March 3. See also Basel Committee on Banking Supervision (2009). Guidelines for computing capital for incremental risk in the trading book, July 1 ("The decision was taken in light of the recent credit market turmoil where a number of major banking organizations have experienced large losses, most of which were sustained in the banks' trading books."). See also Dennis M. Kelleher, Marc Jarsulic, and David Frenk, "Re: Prohibition on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds," Comment Letter, Better Markets, February 13th, 2012, available at https://www.bettermarkets.com/rulemaking/better-markets-comment-letter-volcker-rule.

funds were put at risk to stabilize the financial sector.[3] The federal government provided several temporary liquidity facilities, guaranteed debt issuance, and directly injected capital into financial institutions to prevent an even more devastating financial crisis.

The Effects of the Volcker Rule

There is little question that the post-crisis behavior of securities dealers collectively has changed significantly compared to the pre-crisis period. The total assets of securities brokers and dealers have declined from a peak value of about $5 trillion in 2008 to about $3.5 trillion in 2016, about the level they attained in 2005. Corporate bond holdings follow a similar pattern, peaking at over $400 billion in 2007, and declining to something above $100 billion in 2015.[4] The decline in corporate inventories is at times attributed to the Volcker Rule and other regulatory change.

However, the connection between the decline in bond inventories and the Volcker Rule is in reality not very strong. As analysts for Goldman Sachs have pointed out, the very large run-up in corporate bond inventories pre-crisis reflects the accumulation of positions in private label mortgage backed securities rather than traditional corporate bonds. They estimate that the declining issuance and collapsing prices of private mortgage backed securities explains the decline in dealer inventories from their peak levels in 2007 through 2012.[5]

[3] U.S. Government Accountability Office (2013), p. 14-15
[4] Adrian et al. (2016), pp. 5, 17
[5] Goldman Sachs Credit Strategy Research (2013), p. 5

Moreover, while critics of the Volcker Rule have long forecast dire consequences for the corporate bond market – including declining liquidity, and harm to the functioning of the capital markets[6] – these negative effects have not materialized.

Liquidity, which is usually thought of as the cost of quickly converting an asset into cash, is typically measured by a range of indicators. These include the bid-ask spread, price impact, and trade size. Data on each of these indicators does not show deterioration of corporate bond liquidity.

Bid-ask spreads, which measure the difference between the price at which a dealer is willing to pay for a bond and the price for which he is willing to sell it, is considered an important measure of liquidity. The cost of executing a trade of limited size is generally calculated as one half the bid-ask spread. The spread in the corporate bond market – for investment grade and high-yield bonds – has declined since hitting a peak in the financial crisis and is now lower than in the pre-crisis period.[7]

A standard measure of price impact has declined for both investment grade and high-yield bonds since the crisis, and is now very low relative to pre-crisis levels.[8]

Trade size declined during the financial crisis, and has not yet recovered to pre-crisis levels. While by itself this might be taken as a measure of decreased liquidity – since traders might be avoiding larger trades because of their effect on price – the declines in price impact are inconsistent with that explanation.

The turnover ratio, which is measured as the percent of an issue that trades on a given day, has drifted downward for the most actively traded bonds since 2002. This may be a

[6] Oliver Wyman and SIFMA (2011)
[7] Adrian et al. (2016), p. 24; International Organization of Securities Commissions (2017), p. 39
[8] Ibid.; Mizrach (2015); IOSCO (2017)

function of changes in market structure. First, the number of issues that are traded in the secondary market has risen dramatically. In 2015 more than 33,000 issues were traded, an increase of 12,000 issues over 2003.[9] Under these conditions, the ability of investors to select portfolios from a broader range of issues can translate into declining turnover. In addition, the rising share of outstanding issues held by bond exchange traded funds, who tend to buy and hold, may have contributed to declining trading in the underlying bonds.[10]

Based on these and other data, the general conclusion of several studies, by Adrian et al. (2016), Mizrach (2015), Trebbi and Xiao (2016) and Bessembinder et al. (2016) is that there has not been a significant reduction in corporate bond liquidity between the pre-crisis and post-crisis periods.[11]

While on average liquidity appears be as good or better than it was pre-crisis and pre-Volcker, it is still possible that the inability of big bank dealers to hold proprietary inventories may make the corporate bond market more vulnerable to market shocks.

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[9] Mizrach (2015), p.2

[10] *See* https://www.blackrock.com/corporate/en-lm/literature/whitepaper/viewpoint-addressing-market-liquidity-july-2015.pdf.

[11] The paper by Bao at al. (2016) is an exception. It concludes that differences in price declines in bonds which have been downgraded from investment grade to below investment grade before and after 2014 show that bond markets have become less liquid because of the Volcker Rule. There are, however, some methodological issues unanswered by this analysis. First, it does not control for the fact that many of the institutions downgraded in their post-2014 sample (at least 19 out of 55) are tied to the oil and gas sectors, which were under considerable stress in this period. Hence the observed price declines may be a function of objective changes in the expected returns on the bonds themselves, rather than diminished market making capacity. Second, the study assumes that the price effects of the Volcker Rule begin with the formal implementation of the Volcker Rule by the Federal Reserve in 2014. However, banks took steps to change their trading behavior before 2014, doing things such as selling off or reducing the scale of named proprietary trading desks. Therefore, the smaller price declines observed before 2014 may also reflect the impact of the Volcker Rule-induced changes in bank behavior.

Economists at the Federal Reserve Bank of New York have looked at this possibility empirically.[12] They first developed a general measure of overall bond market illiquidity, which is a function of three measures of liquidity – the bid-ask spread, price impact, and price dispersion. This index is well below both crisis and pre-crisis levels.

They then calculate the frequency of large day to day movements in market illiquidity to measure the changes in liquidity risk. They find that liquidity risk is well below crisis levels and has declined in recent years.

The forecasted harm to corporate access to capital has also failed to appear. New issues of corporate bonds are at record levels, at or above $1 trillion for the period 2010-2015.[13]

Conclusion

In conclusion, it seems fair to say that the exit of large banks from proprietary trading has not had a measurable effect on corporate bond market liquidity, liquidity risk, or the ability of corporations to raise funds in the capital market. With respect to these criteria, our bond markets are functioning at least as well as, if not better than, they were in the pre-crisis period.

It is important to remember, however, that there is no reason to expect market makers, or any other financial market participants, to act as shock absorbers at times of extreme stress. Market makers will buy assets if they expect to profit from their purchases. In a highly uncertain environment, they will not step in to catch a falling knife and cushion

[12] http://libertystreeteconomics.newyorkfed.org/2015/10/has-liquidity-risk-in-the-corporate-bond-market-increased.html.
[13] Mizrach (2015), p. 1.

large price declines. If we want to avoid the problems generated by asset bubbles, and the crashes that follow them, we need to take preventative measures.

The Dodd Frank Act – which requires banks and nonbanks to put more equity on the line when they engage in asset purchases, raises the equity requirements when assets are funded with short-term runnable credit, requires that balance sheets include sufficient liquid assets to deal with shocks, and gets banks out of the business of proprietary trading – provides needed protections. Demolition of these preventative measures is likely to be a very costly exercise in historical amnesia.

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