

## HEARING REPORT

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**From:** Patton Boggs LLP  
**Date:** February 4, 2010  
**Subject:** Senate Banking Committee Hearing *“Implications of the ‘Volcker Rule for Financial Stability’”*

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On February 4, 2010, the Senate Banking Committee held a hearing entitled, “Implications of the ‘Volcker Rule’ for Financial Stability.” The witness list is below. The hearing was the second of two hearings examining the President’s recently announced proposal to limit the scope of proprietary trading activities and the size of bank holding companies via a “Volcker rule.”

### **I. Witness List**

- Mr. Gerald Corrigan, Managing Director, Goldman Sachs;
- Professor Simon Johnson, Ronald A. Kurtz Professor of Entrepreneurship, Sloan School of Management, Massachusetts Institute of Technology;
- Mr. John Reed, Retired Chairman, Citigroup;
- Professor Hal Scott, Nomura Professor of International Financial Systems, Harvard Law School; and
- Mr. Barry Zubrow, Executive Vice President, Chief Risk Officer, JPMorgan Chase.

### **II. Executive Summary**

Generally, there appeared to be a lack of political traction for the Volcker rule by either Democrats or Republicans. Chairman Christopher Dodd (D-CT) noted the need to move forward on regulatory reform legislation and appeared opposed to including the Volcker rule in a bill because of its adverse impact on the process of passing legislation in the near future. Ranking Member Shelby (R-AL) among other Republicans expressed skepticism that the Volcker rule addressed the heart of the problem of systemic risk. Highlights of the discussion included:

- **Need for Further International Consensus on the Volcker Rule.** A witness emphasized the need for international consensus on regulatory reform proposals with the increasing convergence of businesses. The G20 has not yet reviewed the Volcker rule.
- **Lack of Detail in the Administration’s Definitions.** Concern was expressed over the lack of a clear definition of “proprietary trading” among other terms.
- **Interconnectedness as the Root Source of Systemic Risk, Rather Than Institution’s Market Share/Size.** Several witnesses emphasized that regulators should focus on the interconnectedness of firms as an indication of systemic risk of a financial institution, rather than the Volcker rule’s emphasis on the size of an institution’s market share of liabilities.

### III. Discussion of Key Issues Raised By Witnesses

Key issues discussed at the hearing included: (1) the need for clarification of issues, including “proprietary trading”; (2) support for Volcker rule, but need for further refinement; (3) size should be measured by the degree of interconnectedness rather than degree of market share; (4) size should be measured as a percentage of GDP; (5) the need for international consensus on proposals; and (6) criticism of capping liabilities of banks.

- (1) **Unclear Definition of “Proprietary Trading”.** Gerald Corrigan, Goldman Sachs, emphasized the need for clarification on the Volcker Rule and what is intended by the proprietary trading proposals. Mr. Corrigan questioned whether the proposals went to the heart of what caused the economic problems. Barry Zubrow, JPMorgan Chase, criticized the lack of clarity and need for a definition of “proprietary trading.” Mr. Zubrow was concerned that if proprietary trading is defined improperly it could pose risks to the market.
- (2) **Support for Volcker Rule, But Need for Further Refinement.** John Reed, Retired Chairman, Citigroup, voiced support for the Volcker Rule and its intention to segregate functions of financial activities. He believes concerns about size has merit and deserves the attention of the Banking Committee. He said the idea of separating the functions of financial groups makes a lot of sense. Sen. Corker commented on Mr. Reed’s support for the separation proposal considering all the groups he put together while at Citigroup. Mr. Reed acknowledged the discrepancy and explained he learned a lot at Citigroup, but as a retired and now private citizen he can speak freely without regard for the shareholders. He also acknowledged while separating out various groups at Citigroup would be good for the economy it would be bad for Citigroup shareholders.
- (3) **Size Should be Measured By the Degree of Interconnectedness Rather than Degree of Market Share.** Both Hal Scott, of Harvard Law School, and John Reed, Retired Chairman, Citigroup, took issue with the Administration’s measuring size of “too big to fail” by the degree of market share. Hal Scott said that the size should be measured by the degree of interconnectedness. Similarly, John Reed indicated that the problem is the interconnectedness of one financial institution to another institution – you could deal with size by having capital requirements for capping intra-industry activity. He supported having instruments traded through exchanges to act as a “circuit-breaker” with regard to those products. He also said you could deal with size by putting limits on leverage for intra-party trading.
- (4) **Size Should Be Measured as a Percentage of GDP.** Simon Johnson, Massachusetts Institute of Technology, supported the Volcker principles, however he said that the size cap of large banks should be based on their percentage of GDP and not as a percentage of market share. Professor Johnson criticized the largest banks as unfair competition in the markets. He noted that the government should consider tightening the size caps of banks, and the largest six banks have assets worth over 60% of the GDP. He cautioned if we allow the large banks to engage in unfair competition we will head in the wrong direction. The size cap should be defined as a percentage of GDP – e.g. for example capped at 3% of the GDP and noted (?) since the 1990s, we have created more system risk as a result of the larger banks.
- (5) **Need for International Consensus on the Proposals.** Hal Scott, of Harvard Law School, noted that without international consensus from the G20 and major market competitors, adopting these proposals would be dangerous. He strongly encouraged moving forward on

regulatory reform initiatives that have already been weighed in on and accepted by the international community, and indicated the Volcker rule should not hold up the larger debate.

- (6) **Criticism of Capping Liabilities of Banks.** Mr. Zubrow, criticized limits on size. He testified the diversified financial firms did not create the economic crisis but rather it was the level of interconnectedness of the firms that caused the government to have to step in with AIG. He said that an artificial cap on liabilities would have negative consequences. Artificially capping liabilities may provide incentive for banks to reduce the growth of assets or the size of their balance sheets, which in turn would restrict ability to give loans to consumers and businesses and invest in government securities. This could undermine the goals of economic stability, growth, and jobs.

### III. **Discussion of Key Issues in Question and Answer Period**

The following is a summary of key issues raised in the question and answer period, including: (1) proprietary trading; (2) whether the already existing tools of regulators are enough; (3) resolution authority; (4) cross-border firms; (5) interconnectedness; and (6) implementation of risk management proposals.

- (1) **Proprietary Trading.** Chairman Dodd inquired whether it is possible to write a rule regarding proprietary trading and have it be iron clad. He has concerns that as soon as they write the rule someone will figure out a work around. Mr. Corrigan and Mr. Zubrow agreed the rule needs to be so narrow as to require a group of traders to be completely and totally walled off with limited funds.
- (2) **Already Existing Tools of Regulators.** Sen. Shelby asked whether regulators presently have the authority to restrict activities, including proprietary trading, and if regulators deem this to be an unsafe practice? John Reed, responded that “prompt corrective action” needs to become a reality and not a slogan. He said that although regulators presently have the power, there have been some cases in the past in which prompt corrective action has not worked as well as it could. Two elements that go into a successful regime is a more aggressive framework for stress testing and reverse stress testing.
- (3) **Resolution Authority.** Sen. Shelby asked whether a resolution authority should not be permitted to bailout an institution that is too big to fail. He noted that Sen. Corker and Sen. Warner are leading the effort to define clear regime for resolution authority. Mr. Zubrow, noted the need for establishment of such a clear regime, that nothing is too big to fail, and taxpayers do not need to be involved in a bailout of too big to fail firms. He said it is important that large complex firms be prepared with regulators for the potential eventuality of going through bankruptcy and into conservatorship. Sen. Shelby commented it is critical to be clear in legislation that nothing is “too big to fail.” Sen. Corker took issue with Mr. Corrigan and Zubrow’s hypothetical of a too big to fail firm going into conservatorship, noting that conservatorship is just another type of bailout. Mr. Corrigan responded conservatorship would conceivably only be for a few days or weeks in order to establish to an orderly wind-down.
- (4) **Cross-Border Firms.** Prof. Simon Johnson noted the problem of cross-border firms and different regimes requiring the need for cross-border authority. He said any resolution authority based only on the U.S.’s regime will not be sufficient.

- (5) **Interconnectedness.** Hal Scott noted the importance of resolution authority is the degree of interconnectedness of financial institutions. Therefore, attention needs to be focused on identifying the connections.
- (6) **Implementation of Risk Management Proposals.** Sen. Johnson (D-SD) inquired what problems might arise out of the implementation of the risk management proposals. Mr. Scott responded possible conflicts of interest could arise between the bank and the financial institution but if they are worried about conflicts of interest proprietary trading is not the place to start. There are many other important problems that can be dealt with first.