

STATEMENT BY PAUL A. VOLCKER
BEFORE THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
OF THE
HOUSE OF REPRESENTATIVES
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Mr. Chairman, Members of the Committee:

I appreciate the opportunity to appear before you this morning. You are dealing with critically important issues. The laws passed in the 1930's successfully dealt with the grave weaknesses in the financial system at that time, weaknesses that contributed to the severity of the Great Depression. The legislation you are debating this year should set out a constructive path for a reformed financial system for years ahead.

Now the financial pressures have eased and there are signs of renewed economic growth. There are some on "Wall Street" who would like to return to "business as usual". After all, for a time, and for some that system was enormously remunerative. However, it placed at risk not only the American economy, but also large parts of the

world economy. The challenge is not to paper over or tinker around the edges of the broken system. We need to minimize the danger that the uncertainties and risks inherent in the functioning of a market-based financial system do not again jeopardize the functioning and foundation of our economy.

Over recent months the Administration has set out important proposals which, taken together and implemented, would provide a reformed framework for financial regulation and supervision. There are key elements of the Administration's approach that I believe deserve your full support. I particularly welcome the strong reaffirmation of one long-standing principle - the separation of banking from commerce - that has long characterized the American approach toward financial regulation. In practice, over a number of years that approach has been eroded by loopholes in the legal framework and by technological changes in financial instruments and the nature of banking. As emergency measures, further exceptions to the rule were accepted in the face of the severe crisis.

Failure to close those existing loopholes will inevitably weaken needed prudential safeguards and raise difficult questions about the extent of "moral hazard", an issue that looms very large in the light of events of the past year. It is those events - including particularly the rescue of money market mutual funds and the decisions to broaden direct access by non-banks to Federal Reserve credit facilities - that point to the need for strong enforcement of the distinction between banks and other financial or commercial institutions.

Important parts of the Administration's proposed reforms can be - and some are being - implemented and enforced under existing authority. The Treasury has set out principles for capital and liquidity standards. Other prudential approaches are under consideration. Most notably risk management practices, for banks and certain other regulated institutions have been placed under urgent review. At the supervisors' initiative, useful and needed steps are being taken to encourage more prudent compensation practices.

Registration and certain reporting requirements for hedge funds and private equity funds will require your support. Substantial progress is being made on a voluntary basis in the area of derivative markets, including particularly in clearance and settlement arrangements. That work will also need to be reinforced by further grants of legislative authority to appropriate regulatory agencies, including clarification of the overlapping jurisdiction of the SEC and the CFTC.

These are needed steps toward a stronger reformed financial system. However, I want to emphasize two inter-related issues of fundamental importance that run across the more particular elements of reform. One is a matter of broad regulatory practice: how to deal with the insidious, potentially risk-enhancing, spread of "moral hazard", the presumption that systemically important institutions may be protected in the face of imminent failure. The overlapping question is one of administrative responsibility: in particular the appropriate role of the central bank (the Federal Reserve) in regulation, supervision and oversight of the financial system.

However well justified in terms of dealing with the extreme threats to the financial system in the midst of crisis, the emergency actions of the Federal Reserve, the Treasury, and ultimately the Congress to protect the viability of particular institutions - their bond holders and to some extent even their stockholders - have inevitably left an indelible mark on attitudes and behavior patterns of market participants.

- Will not the pattern of protection for the largest banks and their holding companies tend to encourage greater risk-taking, including active participation in volatile capital markets, especially when compensation practices so greatly reward short-term success?
- Are community or regional banks to be deemed "too small to save", raising questions of competitive viability?

- Does not the extension of support to non-banks, and even to affiliates of commercial firms, undercut the banking/commerce divide, ultimately weakening the commercial banking system?
- Will not investors in money market mutual funds find reassurance in the fact that when push came to shove, the Treasury with an extreme interpretation of its authority, took action to preserve those funds ability to meet their declared commitment to pay their investors at par upon demand?

What all this amounts to is an unintended and unanticipated extension of the official "safety net", an arrangement designed decades ago to protect the stability of the commercial banking system. The obvious danger is that with the passage of time, risk-taking will be encouraged and efforts at prudential restraint will be resisted. Ultimately, the possibility of further crises - even greater crises - will increase.

There is no easy answer, no one-size fits all contingencies. Experience, not only here but in every country with highly developed, inter-connected financial systems and institutions bears out one point. Governments are not willing to withhold financial and other support for failing institutions when there is a clear threat to the intertwined fabric of the financial system. What can be done is to put in place arrangements to minimize the extent of emergency intervention and to damp expectations of government "bailouts".

The approach proposed by the Treasury is to designate in advance financial institutions "whose size, leverage, and interconnection could pose a threat to financial stability if it failed". Those institutions, bank or non-bank, connected to a commercial firm or not, would be subject to particularly strict and conservative prudential supervision and regulation. The Federal Reserve would be designated as consolidated supervisor. The precise criteria for designation as "systemically important" have not, so far as I know, been set out. However, the clear implication of such designation whether officially acknowledged or not will be that such institutions, in

whole or in part, will be sheltered by access to a Federal safety net in time of crisis; they will be broadly understood to be "too big to fail".

Think of the practical difficulties of such designation. Can we really anticipate which institutions will be systemically significant amid the uncertainties in future crises and the complex inter-relationships of markets? Was Long Term Capital Management, a hedge fund, systemically significant in 1998? Was Bear Stearns, but not Lehman? How about General Electric's huge financial affiliate, or the large affiliates of other substantial commercial firms? What about foreign institutions operating in the United States?

All hard questions. In practice the "border problem" seems intractable. In fair financial weather, the important institutions will feel competitively hobbled by stricter standards. In times of potential crisis, it would be the institution left out of the "too big to fail" club that will fear disadvantage.

I have done a little informal polling among friends familiar with financial markets. I asked, outside of commercial banking and insurance organizations already subject to substantial official regulation, how many financial institutions in the world should be considered systemically significant and protected from failure? The answers range from about 5 to maybe 25 or so.

Of course, we can't really know, not in this day, when "black swans" seem to be appearing more frequently, when sub-prime mortgages arise out of nowhere in a few years to undermine market stability, when opaque trading in complex derivatives become so large relative to underlying assets, and when more and more complex financial instruments limit the transparency of markets.

Rather than designate some particular systemically important institution, I take a more traditional view. Commercial banks, taken collectively, are certainly systemically important. Their basic role is to provide vital basic services to customers - payment services, a safe depository for liquid funds, credit for individuals

and businesses and financial advice. Since Adam Smith wrote his classic work, and even before, the risks of bank failures impairing economic activity have also been recognized.

The United States, as virtually all developed countries, for decades, ranging in our case back to the National Banking and the Federal Reserve Acts, have maintained a substantial supervisory and regulatory apparatus. It indeed is timely here in the U.S., as elsewhere, to review those arrangements and the particular responsibilities of the agencies involved. However that is resolved, it should be natural that the larger and more complicated banking institutions be subject to particularly close surveillance and supervision, with guidelines for capital, executive compensation and risk-management procedures enforced in the normal course of examinations.

As a general matter, I would exclude from commercial banking institutions, which are potential beneficiaries of official (i.e., taxpayer) financial support, certain risky activities entirely suitable for our capital markets.

Ownership or sponsorship of hedge funds and private equity funds should be among those prohibited activities. So should in my view a heavy volume of proprietary trading with its inherent risks. Some trading, it is reasonably argued, is necessary as part of a full service customer relationship. The distinction between "proprietary" and "customer-related" may be cloudy at the border. But surely by the active use of capital requirements and the exercise of supervisory authority, appropriate restraint can be maintained.

The point is not only the substantial risks inherent in capital market activities. There are deep-seated, almost unmanageable, conflicts of interest with normal banking relationships - individuals, businesses, investment management clients seeking credit, underwriting and unbiased advisory services. I also think we have learned enough about the challenges and distractions for management posed by the risks and complexities of highly diversified activities.

If the commercial banking system is to be protected and fit comfortably within the existing official safety net, there still will be potential problems with other risk-taking institutions active in the capital markets. I have suggested that, insurance companies apart, only a few such institutions are likely to pose truly systemic risk. Registration and reporting by hedge funds and private equity funds (above some de minimus size) should enable the relevant regulator to assess dangerous degrees of leverage, capital inadequacy, or other particularly risk-prone activity by particular institutions.

As a matter of broad policy, an assumption that those non-bank institutions would come into the framework of the Federal safety net should be discouraged. The credibility of that approach will need to be supported by legislation. A designated regulatory agency will need to be provided authority to set rules for capital, leverage, and liquidity for those few institutions that may be large enough to pose systemic risk.

I also believe an approach proposed by the Administration and others should be supported. The basic concept is to provide a new "resolution regime" for insolvent or failing non-bank institutions of potential systemic importance. What is envisaged is appointment of a "conservator" or "liquidator" to take control of a financial institution defaulting, or in clear danger of defaulting, on its obligations. Authority should be provided to negotiate the exchange of debt for new stock if necessary to maintain the continuity of operations, to arrange a merger, or to arrange an orderly liquidation.

That authority, as I see it, is essential to both the Administration's approach and certainly to the approach I advocate. I recognize such an authority, preempting established bankruptcy proceedings, would be justified only by the exceptional and particular circumstances of a systemic breakdown. The approach is not, however, unprecedented. The FDIC has long had analogous authority for insured banks.

The events of the past year here and abroad have also emphasized the need for broad surveillance of the financial system. In the past, the focus has been largely on supervision of individual institutions. What has been lacking amid the rapid changes in markets and instruments is a sense of how different institutions may be interacting, and what new developments may be presenting new risks and require a regulatory response. (The rapid development of sub-prime mortgages and credit default swaps are recent examples of inadequately recognized destabilizing developments.)

To my mind, in most countries, and in the United States, it is to the central bank that we have looked for broad assessment of financial markets and to maintain continuity in markets, even if that responsibility is not spelled out in statute. It is, without doubt, the central bank to which governments, market participants, and the public look to in time of crisis. It is, after all, an extension of the responsibilities implied by the original Federal Reserve Act at the time when, effectively, banks were the financial system. It is, of course, only the Federal Reserve that has the resources to lend freely at

short notice, a matter well demonstrated in the past crisis.

I understand, and share, concern that the financial crisis has revealed weaknesses in our regulatory and supervisory agencies as well as in the activities of private financial institutions. There has been criticism of the Federal Reserve itself, and even proposals to remove responsibilities other than monetary policy, strictly defined, from the Fed.

I believe, based on many years experience, that would be a mistake. For one thing, enforcing a separation of monetary policy and supervisory policy would not serve either function well. The Federal Reserve Board should not become an academic seminar debating in its marble palace various approaches toward monetary policy without the leavening experience of direct contact with, and responsibility for, the world of finance and the institutions through which monetary policy is effected.

If some sense of that interconnection has been lost in recent years, even as destabilizing bubbles in the stock and mortgage market evolved, it should be reinforced by organizational changes. I am not alone in suggesting that a Fed governor should be nominated by the President and confirmed by the Senate as a second Vice Chairman of the Board with particular responsibility for overseeing Regulation and Supervision. The point is to pinpoint responsibility, including relevant reporting to the Congress, for a review of market developments and regulatory and supervisory practices. Staff authority, independence, professionalism, experience, and size should be reinforced.

Quite simply, it is the Federal Reserve that has (surely should have) the independence from political pressures, the prestige and the essential qualifications of experience to serve as overseer of the financial system. It should have ample authority to obtain needed information from both other regulatory agencies and from financial firms, to work with those agencies in identifying weaknesses in market institutions and practices, and, if necessary to call for changes in regulatory practice.

The Treasury, fully recognizing the need for such broad oversight, has essentially recommended a council of regulatory agencies under Treasury chairmanship. I write with some confidence that a council of variegated agencies with their own particular challenges, policies, and constituencies cannot be expected to efficiently and effectively serve as a coordinating body. In practice, the burden would be on the Treasury, an agency for which I have had enormous respect and pride and in which I have served in my years in Government. I also know that it would need to build staff, competence and experience in the regulatory arena from a standing start. It is subject more directly to funding constraints and political forces and direction that may inhibit action. The needed cooperation and coordination of regulatory and supervisory practice internationally has been, and I think should remain, heavily dependent on national central banks, most of which have a substantial role in prudential regulation.

In sum, I believe the needed oversight and coordinating role should be in the hands of the Federal Reserve rather than the Treasury. In considering the

responsibilities of the Federal Reserve, it does seem to me entirely appropriate that when under "unusual and exigent" circumstances the Fed is called upon to use emergency lending powers, it seek the formal assent of the President through the Treasury. I believe that has, in any event, properly been done as a matter of practice. However, with taxpayer money ultimately at risk, there should be no doubt about approval for the exercise of the emergency authority.

There is also an interesting question as to the period over which events are both "unusual and exigent". What is involved in emergency lending is the need to act immediately and forcefully, which only the Fed may be able to do. But after several months, the Congress working with the Administration should be able to determine the proper amount and time for continuing extraordinary assistance.

This is already a long statement, and I cannot cover other important points at issue, including protection for consumers and investors involved in financial transactions. In time, Congress must direct its attention to rebuilding the national mortgage market, avoiding, I trust, the now

failed approach of mingling private and public responsibilities of so-called Government Sponsored Enterprises. I also urge consideration of making a national insurance charter available to insurance companies willing to accept Federal prudential standards. Large issues with accounting and credit rating agencies remain.

Those are matters for another day. What is critically important is to establish now the basic framework for regulation and supervision, in the process recognizing the special role of the central bank. Going forward, I also urge that the United States recognize the need to coordinate with the authorities of the other major countries regarding the oversight of international banking organizations, the open and timely sharing of information, and greater clarity on home and host responsibilities, including dealing with failing institutions. This will greatly assist in the closing of regulatory gaps, and raise standards, and help in developing a "level playing field".