

REMARKS BY PAUL A VOLCKER
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THE ROLE OF THE FEDERAL RESERVE
IN A NEW FINANCIAL ORDER

Twenty months have passed since I last addressed the Economic Club of New York. The sudden demise of Bear Stearns had happened only a few days before. That event, and the market turbulence that accompanied it, had already justified labeling what had seemed a containable sub-prime mortgage crisis as the "mother of all crises".

The events of the Fall of 2008 drove the point home. For a few weeks the whole financial world seemed to be tottering on the edge of a nervous breakdown. Only aggressive intervention by the Treasury and the Federal Reserve in this country, and similar initiatives in the U.K. and in other parts of Europe, restored even a precarious sense of stability. Those actions by the national authorities went far beyond the established role of central banks as lenders of last resort. Several trillion dollars, in substantial part budgetary funds, were spent in the United States to support markets and financial institutions, bank and non-bank. In effect, institutions and markets that had been proud and profitable exemplars of modern finance became wards of the state, de facto if not de jure. In sum, the world of finance was turned upside down.

By now, there are signs of return to more normal conditions. The economy seems to be slowly growing. Large banks, emerging from Government support and benefitting from the flood of liquidity are reporting large operating profits. Real progress is being made in restoring capital ratios even as loan losses continue. Risk premia seem more normal. Funds are flowing, if not yet in all markets at needed volume.

In the circumstances, some market participants, possibly some in this room, seem to be suggesting that the events of the past couple of years were like a bad dream -

a truly unsettling bad dream, but nonetheless something that in the cold light of day need not require a really substantial change in the structure of markets or corporate life style. Better board oversight, a tightening of institutional risk management practices, more adequate capital and liquidity standards, better informed and abler regulators, a review of credit rating practices, certainly more sensible and uniform accounting practices - the sort of thing I characterize as "reform light" should be adequate to do the job.

But surely the need is more fundamental. This latest crisis has been cited as a once in a century - or maybe once in a generation - affair. But do not forget it is only the latest in a string of crises over the past 30 years that seemed to be growing in both frequency and intensity. Even more significant, the forceful official responses necessarily were undertaken in the white heat of crisis, without the luxury of time or the benefit of established emergency procedures and financial resources. We are left with a residue of really fundamental questions about the appropriate role of government in rescuing failing institutions and markets. The old questions colloquially described as "too big to fail" loom larger than ever.

I don't think in the light of all that has happened that we can escape dealing more clearly with the question of moral hazard. That is the elephant in the room - or perhaps I should say in the halls of Congress. It is not going to go away. Unless we can develop a reasonable, well understood approach, then all these other reforms - all those potentially useful efforts to improve financial housekeeping - won't provide the reassurance we need.

My sense is that the Administration, the Congress and other national authorities, have a common interest in achieving an intellectually satisfying and workable consensus. Given the inherent complexity and different national and private interests at stake, as well as the competing Congressional priorities, the fact that the process has taken time is understandable. It is important that we get it done, and get it done right. All the interests refusing to recognize the need for real change must not hold sway.

Illustrative of the resistance is the push back against the Administration's efforts to work toward fail-

safe procedures for the clearing and settlement of derivatives and to insist on greater responsibility in sponsoring collective debt instruments.

I have not been restrained in recent weeks and months in setting out my own view on what I perceive to be one key element in strengthening the financial structure. My starting point is that for all the innovations in the market, commercial banking organizations are still the indispensable backbone of the financial system. Today they comprise almost all the institutions of truly systemic importance. In recognition of that fact, I do not think the United States or other countries should or will eliminate the basic "safety net" for commercial banks - deposit insurance and access to a lender of last resort balanced by appropriate regulation and close supervision. But I also believe we ought to recognize that some areas of finance, as well as ownership ties with commercial firms, are inappropriate for banking.

I have cited, in particular, hedge funds, private equity funds, and proprietary trading in that respect. The point is that they present added risk and virtually unmanageable conflicts of interest with more essential customer relationships. Those market oriented activities are appropriate for our broader capital markets, but should not, implicitly or explicitly, be provided safety net support. I also believe that very few of the institutions engaged in those activities are systemically important.

Instead of bringing these activities and the capital market institutions within the safety net, a special new "resolution authority" should be created, a point the Administration has consistently advocated. That authority should be empowered to take control of financial institutions that are approaching failure, arranging as appropriate either an orderly liquidation or merger. In no case should that amount to a "rescue" in the sense of protecting either management or stockholders; some creditors would be at risk as well if assets in fact ultimately prove to fall short of liabilities.

This afternoon, I rather want to spend my time on a closely related area of reform that is of critical importance but, surprisingly to me, has become highly controversial. What has been particularly disturbing is the position of some that the Federal Reserve should be

largely, even completely, shorn of its regulatory and supervisory responsibilities.

You will not be surprised to hear me say that I reject that view. What seems to me beyond dispute, given recent events, is that monetary policy and the structure and condition of the banking and financial system are irretrievably intertwined. Those reciprocal influences and the interdependence make a compelling case that central banks should have a strong voice and authority in regulatory and supervisory matters.

"I do not want to deny that there are other legitimate public interests in regulatory policy, not least of the finance ministry. Ways and means can be found to bring a variety of points of view to bear. But I would insist that neither monetary policy nor the financial system will be well served if a central bank loses interest in, or influence over, the structure and performance of the financial system.

"The clear challenge for central banks and their colleagues in the regulatory process over the next few years will have to reinforce confidence in the banking system while weaning it away from excessive reliance on official support".

These two paragraphs in my text were the easiest for me to put on paper. In fact, they were lifted word for word from a lecture I gave 20 years ago.

What I want to do is place those old words into today's context.

Only 10 days or so ago, Chairman Bernanke made the relevant point. If we are concerned about identifying and dealing with financial bubbles - and I think we should be - we need both the ability to identify the danger points and have the instruments to deal with them. We might debate the extent to which the blunt instrument of monetary policy can and should be brought to bear. But to be timely, to be effective, to act with anything approaching surgical skill, supervisory and regulatory tools are relevant. As appropriate, those tools will need to be coordinated with decisions with respect to monetary policy.

The practical fact is that the Federal Reserve in executing open market operations and acting as Treasury agent is in the financial markets day by day. It is inescapably dependent upon the efficient functioning of those markets. In acting as lender to banks it must know its counterparties, and know them well. At times of crisis, those relationships will be intensified, and we have just been witness to extreme examples of that. A related point is that the Federal Reserve both oversees and participates in the basic payments system; large value payments, domestic and international, routinely pass through its own books.

What other official institution has the knowledge, the expertise, the experience to identify and evaluate market conditions, to judge the risks, protect its own position and act on short notice, overnight if necessary?

The basic structure of the Federal Reserve System is also relevant. It is an elaborate, in some ways cumbersome, organization, deliberately so. It is designed to protect its independence within government, to assure an element of regional participation, and to maintain contact with financial, commercial and agricultural interests. The fact that it has remained pretty much intact for close to a century itself suggests the genius of its founders.

These days, bestselling books remind us that challenges to that structure, and particularly to the Fed's insulation from political pressure, arise from time to time. The sense of anger about the amounts of funds required to "bail out" both institutions and markets is palpable. But that truly exceptional response to financial crisis - drawing on long dormant emergency powers - was a properly coordinated decision with the Administration, not a misuse of independent authority.

A more limited critique is that authorities responsible for maintaining the safety and soundness of particular banks and financial institutions should not be "distracted" (if that is the right word) by potentially competing objectives of monetary policy. Or conversely, the Federal Reserve, preoccupied with monetary policy will, consciously or unconsciously, not give enough attention to supervision responsibilities. I believe neither point can be sustained. There are times when supervisory and monetary policies must work in harmony.

It simply doesn't make sense, as then Fed chairman Mariner Eccles complained during the Great Depression, that the efforts of the Federal Reserve to ease money be to some degree frustrated by overzealous banking regulators determined to restore bank capital and assure strong lending standards. Nor would it help if banking regulators are reluctant to tighten capital or other supervisory standards of particular institutions at a time of incipient excesses in banking and financial markets more generally.

None of this, to my mind, is an argument for exclusive regulatory and supervisory authority to lie in the Federal Reserve. To the contrary, there is merit to some division of responsibilities. The FDIC, for instance, brings to the table a far flung examiner staff with an immense amount of experience in dealing with troubled banks. Clearly we do not want competition in laxity among a number of regulators closely aligned with particular constituencies. But equally there is a danger that a single regulator may be excessively rigid and insensitive.

There is more than one suitable model for the United States or for other countries. I do insist, however, that whatever the particular model that emerges from the present revision, the central bank should maintain a robust presence with real authority in regulatory and supervisory matters, a point of view strongly supported by the present Administration.

Recall that the original Federal Reserve Act almost 100 years ago set out in its preamble as one of the main purposes of the new institution "a more effective supervision of banking". In those days, commercial banks, for all practical purposes, were the financial system, and when bank holding companies became significant, Federal Reserve responsibility was extended to bank affiliates.

In practice, those responsibilities have been shared with the Comptroller of the Currency, the FDIC, state agencies, the SEC and some more specialized organizations. Plainly, some consolidation is called for. In considering that needed reorganization, I would remind you that it is the Federal Reserve to which the Congress, successive Administrations, the general public, and not least financial institutions themselves have looked to in times of trouble.

As my predecessors and successors have been well aware, when the crisis breaks, it is their telephone that rings and the ensuing conversations have a great sense of urgency. That has been true whether the emergency was the collapse of the silver market or the Latin American debt crisis early in the 1980's, major bank and thrift institution failures later in that decade, the Asian crisis and an overleveraged hedge fund in the 1990's, more recently troubled investment banks and a foundering mortgage market.

That is not a matter of narrowly defined responsibilities closely defined by law. Rather, it reflects a certain confidence in the central bank as both independent and professionally qualified. It implicitly recognizes the reciprocal influences and interdependencies among institutions and between monetary policy and regulatory concerns that I emphasized earlier.

Of course, there is a further and very tangible consideration: it is the central bank that has financial resources immediately available; if more money is needed, well, that can be created.

What the current crisis has brought to our attention is that concerns about financial stability cannot be confined to a crisis in being. The Administration's proposals for regulatory reform, the recent remarks of Chairman Bernanke, and of many foreign authorities, the G-30 Report a year ago, and many other private analysts have called for arrangements to provide broad oversight of financial markets and institutions - what I term a "systemic overseer".

The point is that there is a functional distinction between broad oversight of the system and enforcing regulatory and supervisory authority over particular institutions. It is concern about the interdependence of those institutions, about trends in leverage and risk management generally, about the framework of markets and the significance of new institutions and innovations for containing (or perhaps amplifying) risks.

The Administration appropriately and strongly has set forth that rationale. While affording a strong regulatory role for the Fed, it contemplates the further oversight

role be centered in the Treasury, chairing and staffing a rather large "council of regulators". The alternative, as I see it, is to lodge that responsibility explicitly in the Federal Reserve. That approach would be consistent with the broad responsibilities of the central bank. Operationally it would build upon its experience, its existing professional staff, its strong regional presence, and its tradition of broad consultation with banks and other financial institutions, with the business community and the public at large.

Whatever the particulars, a close relationship among regulatory authorities, encouraged by an advisory council or otherwise, would be essential. The new "overseer" would clearly need adequate authority to collect information. Consideration needs to be given to what elements of regulatory authority beyond the implicitly powerful tool of moral suasion would be needed.

The present crisis has exposed weaknesses in existing approaches of all the regulatory agencies. I am acutely aware that is particularly true of the Federal Reserve itself which, as I see it, carries the broadest responsibilities and has access to the greatest resources. The appropriate response, for all the reasons I have set out, must not be to denude the Federal Reserve of supervisory and regulatory responsibilities. Rather, there must be legislation and reforms to clarify those responsibilities. We need assurance that the regulatory responsibilities will be consistently respected at the top of the institution, by the Board of Governors and by the managements of the regional banks.

Designation of the Federal Reserve as the systemic overseer would itself carry a strong message as to its responsibilities. Within the organization, I do believe there is a clear need for a stronger administrative focus. In that respect, I can only repeat and reinforce the suggestion I made in speaking here more than a year ago that one Board member be designated as Vice Chairman for Supervision with direct responsibility for managing the effort of the entire Fed System. The position would be subject to Senate confirmation, with a requirement for reporting at intervals to the relevant Congressional committees on the "State of the Financial System". Consistent with the new framework, emphasis on the

oversight and supervisory responsibilities of the Reserve Bank presidents should be emphasized.

Looking to the composition of the Reserve Board and the Open Market Committee, I do not believe those bodies should be viewed as a kind of academic conclave to which professional economists have a special entry ticket. Economic training can, indeed, provide a strong analytic focus and an important sense of discipline for central banking. Understanding the significance and limitations of data as they become available, and awareness of inter-connections between market behavior and policies is important. But a profession that has become more and more abstract, abstruse and mathematical, also has limitations in providing insight into human and institutional behavior. The Board will always benefit by some members drawn from business (large and small), from finance generally or banking in particular, and from those with experience in public life. Surely, the regulatory and supervisory staff must attract some of the nation's best talent - certainly professional economists, but also financial engineers, auditors, and risk management experts, ready and eager to accept the challenge of participating in public service.

I will conclude by placing the role of the Fed in a broader setting.

The United States is still the world's largest economy. It has been the exemplar of the benefits of a market system. One hallmark of leadership has been innovative financial markets. The United States is the home of large and active financial institutions internationally. Our influence has been pervasive right around the world.

Now it is clear that leadership can no longer be taken for granted as a kind of birthright carried over from the 20th century. In relative terms, neither our economy nor our financial system has unquestioned dominance. We are plainly overextended in budgetary terms and in our dependence on foreign capital; we resort to the "kindness of strangers" to meet our deficits. The great recession and the collapse of some of our largest and proudest financial institutions have carried an ominous message of vulnerability.

I am confident we can make our way back to a healthy economy and to a strong and stable financial system privately owned and operated. But it is also evident that

the simple and essential quality of trust is in short supply whether within our country or abroad.

We must not shrink away from change but accept the need for basic financial reform. In undertaking that job, let us also recognize that this is no time to weaken the role of the one economic institution - our central bank - that has long commanded a sense of respect and confidence not only among Americans but right around the world. Political leaders and market participants alike have looked to the Federal Reserve as guardian of stability of the financial system in general and the dollar in particular.

I do too.

We simply cannot afford inadvertently to undermine that sense of trust.

If you agree I urge you to make your voices heard.