STATEMENT OF PAUL A. VOLCKER
BEFORE THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE
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Mr. Chairman and Members of the Senate Banking Committee

I appreciate your invitation to discuss the recent Report on Financial Reform issued by the “Group of 30”. I remind you that the Group is international, bringing together members with broad financial experience from both the private and public sectors and drawn from both highly developed and emerging economies. While certainly relevant to the United States, most of the recommendations are generally applicable among globally active financial markets.

I understand that the text of the Report has been distributed to you and your staff and will be included in the Committee record. Accordingly, my statement will be short.

What is evident is that we meet at a time of acute distress in financial markets with strongly adverse effects on the economy more broadly. There is a clear need for early and effective governmental programs both to support economic activity and to ease the flow of credit. It is also evident that fundamental changes and reform of the financial system will be required to assure that strong, competitive and innovative private financial markets can in the future again support economic growth without risk of a systemic financial breakdown.

It is that latter challenge to which the G-30 Report is addressed. I understand that President Obama and his administration will soon place before you a specific program for dealing with the banking crisis. Such emergency measures are not the subject of our Report. However, I do believe that the implementation of the more immediate measures will be facilitated by an agreed sense of the essential elements of a reformed financial system.

In that respect, the basic thrust of the G-30 Report is to distinguish among the basic functions of any financial system. First, there is a need for strong and stable institutions serving the needs of individuals, businesses, governments, and others for a safe and sound repository of funds, as a reliable source of credit, and for a robust financial infrastructure able to withstand and diffuse shocks and volatility. I think of this as the service-oriented part of the financial system dealing with customer relationships. It is characterized mainly by commercial banks that have long been supported and protected by deposit insurance, access to Federal Reserve credit, and other elements of the Federal safety net.

What has become apparent during this period of crisis is increasing concentration in banking and the importance of official support for systemically important institutions at risk of failure. What is apparent is that a sudden breakdown or discontinuity in the functioning of such institutions risks widespread repercussions on markets, on closely interconnected financial institutions, and on the broader economy.

The design of any financial system raises large questions about the appropriate criteria for, and the ways and means of, providing official support for these systemically important institutions.

In common ground with virtually all official and private analysts, the Report calls for “particularly close regulation and supervision, meeting high and common international standards” for institutions deemed systemically critical. It also explicitly calls for restrictions on “proprietary activities that present particularly high risks and serious conflicts of interest” deemed inconsistent with the primary responsibilities of those institutions. Of relevance in the light of recent efforts of some commercial enterprises to recast financial affiliates as bank holding companies, the Report strongly urges continuing past U.S. practice of prohibiting ownership or control of government-insured, deposit-taking institutions by non-financial firms.

Secondly, the Report implicitly assumes that, while regulated banking institutions will be dominant providers of financial services, a variety of capital market institutions will remain active. Organized markets and private pools of capital will be engaging in trading, transformation of credit instruments, and developing derivatives and hedging strategies, and other innovative activities, potentially adding to market efficiency and flexibility.

These institutions do not directly serve the general public and individually are less likely to be of systemic significance. Nonetheless, experience strongly points to the need for greater transparency. Specifically beyond some minimum size, registration of hedge and equity funds, should be required, and if substantial use of borrowed funds takes place, an appropriate regulator should be able to require periodic reporting and appropriate disclosure. Furthermore, in those exceptional cases when size, leverage, or other characteristics pose potential systemic concerns, the regulator should be able to establish appropriate standards for capital, liquidity and risk management.

The Report does not deal with important and sensitive questions of the appropriate administrative arrangements for the regulatory and supervisory functions. These are in any case likely to be influenced by particular national traditions and concerns. What is emphasized is that the quality and effectiveness of prudential regulation and supervision must be improved. Insulation from political and private special interests is a key, along with adequate and highly competent staffing. That implies adequate funding.

The precise role and extent of the central bank with respect to regulation and supervision is not defined, and is likely to vary country by country. There is, however, a strong consensus that central banks should accept a continuing role in promoting and maintaining financial stability, not just in times of crisis, but in anticipating and dealing with points of vulnerability and risk.

The Report deals with many more specific issues cutting across all institutions and financial markets. These include institutional and regulatory standards for governance and risk management, an appropriate accounting framework (including common international standards), reform of credit rating agencies, and appropriate disclosure and transparency standards for derivatives and securitized credits. Specifically, the Report calls for ending the hybrid private/public nature of the two very large government sponsored mortgage enterprises in the United States. Under the pressure of financial crisis, they have not been able to serve either their public purposes or private stockholders successfully. To the extent the Government wishes to provide support for the residential mortgage market, it should do so by means of clearly designated government agencies.

Finally, I want to emphasize that success in the reform effort, in the context of global markets and global institutions, will require consistency in approach among countries participating significantly in international markets. There are established fora for working toward such coordination. I trust the forthcoming G-20 meeting, bringing together leaders of so many relevant nations, can provide impetus for thoughtful and lasting reform.