STATEMENT TO THE SENATE BANKING COMMITTEE
SUBCOMMITTEE ON CONSUMER PROTECTION

WASHINGTON, DC – MAY 9, 2012

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"Too Big To Fail" – the Key Issue in Structural Reform

The greatest structural challenge facing the financial system is how to deal with the wide-spread impression – many would say conviction – that important institutions are deemed "too large or too interconnected" to fail. During the crisis, creditors – and to some extent stockholders – were in fact saved by injection of official capital and liquidity in the aggregate of trillions of dollars, reinforcing the prevailing attitudes.

Few will argue that the support was unwarranted given the severity of the crisis, and the danger of financial collapse in response to contagious fears, with the implication of intolerable pressures on the real economy. But there are real consequences, behavioral consequences of the rescue effort. The expectation that taxpayers will help absorb potential losses can only reassure creditors that risks will be minimized and help induce risk-taking on the assumption that losses will be socialized, with the potential gains all private. Understandably the body politic feels aggrieved and wants serious reforms.

The issue is not new. The circumstance in which occasional official rescues can be justified has long been debated.[1] What cannot be in question is that the prevailing attitudes and uncertainties demand an answer. And that answer must entail three elements:

First, the risk of failure of "large, interconnected firms" must be reduced, whether by reducing their size, curtailing their interconnections, or limiting their activities.

Second, ways and means must be found to manage a prompt and orderly financial resolution process for firms that fail (or are

[1] Alan Greenspan, 1996

on the brink of failure), minimizing the potential impact on markets and the economy without massive official support.

Third, key elements in the approach toward failures need to be broadly consistent among major financial centers in which the failing institutions have critical operations.

Plainly, all that will require structural change embodied in legislation. Various approaches are possible. Each is difficult intellectually, operationally, and politically, but progress in these areas is the key to effective and lasting financial reform.

I think it is fair to say that in passing the Dodd-Frank legislation, the United States has taken an important step in the needed directions. Some elements of the new law remain controversial, and the effectiveness of some of the most important elements are still subject to administrative rule writing. Most importantly, a truly convincing approach to deal with the moral hazard posed by official rescue is critically dependent on complementary action by other countries.

In terms of the first element I listed to deal with "too big to fail" -- minimizing the size and "interconnectedness" of financial institutions -- the U.S. approach sets out limited but important steps. The size of the major financial institutions (except for "organic" growth) will be constrained by a 10% cap on their share of bank deposits and liabilities. That cap is slightly higher than the existing size of the largest institutions, and is justified as much to limit further concentration as by its role as prudential measures.

The newly enacted prohibitions on proprietary trading and strong limits on sponsorship of hedge and equity funds should be much more significant. The impact on the sheer size of the largest U.S. commercial banking organizations and the activities of foreign banks in the United States may be limited. They are, however, an important step to deal with risk, conflicts of interest, potentially compensation practices and, more broadly, the culture of banking institutions.

The justification for official support and protection of commercial banks is to assure maintenance of a flow of credit to businesses and individuals and to provide a stable, efficient payment system and safe depository. Those are both matters entailed in continuing customer relations and necessarily imply an element of fiduciary responsibility. Imposing on those essential banking functions a system of highly rewarded – very highly rewarded – impersonal trading dismissive of client relationships presents cultural conflicts that are hard – I think really impossible – to successfully reconcile within a single institution. In any event, it is surely inappropriate that those activities be carried out by institutions benefiting from taxpayer support, current or potential.

Similar considerations bear upon the importance of requiring that trading in derivatives ordinarily be cleared and settled through strong clearing houses. The purpose is to encourage simplicity and standardization in an area that has been rapidly growing, fragmented, unnecessarily complex and opaque and, as events have shown, risk prone.

There is, of course, an important legitimate role for derivatives and for trading. The question is whether those activities have been extended well beyond their economic utility, risking rather than promoting economic growth and efficient allocation of capital.

There is one very large part of American capital markets calling for massive structural change that so far has not been touched by legislation. The mortgage market in the United States is dominated by a few government agencies or quasi-governmental organizations. The financial breakdown was in fact triggered by extremely lax, government-tolerated underwriting standards, an important ingredient in the housing bubble. The need for reform is self-evident and the direction of change is clear.

We simply should not countenance a residential mortgage market, the largest part of our capital market, dominated by so-called Government Sponsored Enterprises. Collectively, Fannie Mae, Freddie Mac and the Home Loan Banks had securities and guarantees outstanding that exceed the amount of marketable U.S. Treasury securities. The interest rates on GSE securities have been close to those on government obligations.

That was possible because it was broadly assumed, quite accurately as it has turned out, that in case of difficulty those agencies would be supported by the Treasury to whatever extent necessary to maintain their operations. That support was triggered in 2008, confirming the moral hazard implicit in the high degree of confidence that government-sponsored enterprises would not be allowed to fail.

The residential mortgage market today remains almost completely dependent on government support. It will be a matter of years before a healthy, privately supported market can be developed. But it is important that planning proceed now on the assumption that Government Sponsored Enterprises will no longer be a part of the structure of the market.

It is evident that there is not yet full international agreement on elements of the basic structural framework for banking and other financial operations. Some jurisdictions seem content with what is termed "universal banks", whatever the conflicts, risks and cultural issues involved. In the United States, there are restrictions on the activities of commercial banking organizations, particularly with respect to trading and links with commercial firms.

Financial institutions not undertaking on commercial banking activities will be able to continue a full range of trading and investment banking activities, even when affiliated with commercial firms. When deemed "systemically significant", they will be subject to capital requirements and greater surveillance than in the past. However, there should be no presumption of official support – access to the Federal Reserve, to deposit insurance, or otherwise. Presumably, failure will be more likely than in the case of regulated commercial banking organizations protected by the official safety net. Therefore, it is important that the new resolution process be available and promptly brought into play.

In the U.K., another approach has been supported by the current government: a "pure" deposit taking and lending bank would be separated from an investment bank within the holding company. A "ring fence" would strictly limit contact between the two businesses.

As an operational matter, some interaction between the retail and investment banks is contemplated in the interest of minimizing costs and facilitating full customer service. American experiences with "fire walls" and prohibitions on transactions between a bank and its affiliates have not been entirely reassuring in practice. Ironically, the philosophy of U.S. regulators has been to satisfy itself that a financial holding company and its non-bank affiliates should be a "source of strength" to the commercial bank. That principle has not been highly effective in practice, and does not appear to be a part of the U.K. approach.

More broadly, a comprehensive approach internationally is seen to be developing in which systemic oversight is coupled with resolution authority for both banks and non-banks. A dividing line between those activities worthy of government support and those that are not is common to both the U.S. and U.K. approaches.

The Volcker Rule is a part of this formula, and should not be considered in isolation against the total task at hand. Coupled with increased capital requirements, the Dodd-Frank legislation, if fully enforced, is a solid step towards reigning in "too big to fail".

The regulators are still hard at work completing the important rule making, and will soon turn their attention to constructing the supervisory manuals and other tools of enforcement. After the transition period when the legislation and new capital requirements are a functioning part of our financial and supervisory system, not only should risk be reduced but important cultural issues will begin to be addressed.

Unfinished business remains. Money Market Mutual funds are another example of moral hazard, and seem to me more amenable to structural change. By grace of an accounting convention, shareholders in those funds are permitted to meet requests for withdrawals upon demand at a fixed dollar price so long as the market valuation of fund assets remains within a specified limit around the one dollar "par" (in the vernacular "the buck"). Started decades ago essentially as regulatory arbitrage, money market mutual funds today have trillions of dollars heavily invested in short-term commercial paper, bank deposits, and notably recently, European banks.

Free of capital constraints, official reserve requirements, and deposit insurance charges, these MMMFs are truly hidden in the shadows of banking markets. The result is to divert what amounts to demand deposits from the regulated banking system. While generally conservatively managed, the funds are demonstrably vulnerable in troubled times to disturbing runs, highlighted in the wake of the Lehman bankruptcy after one large fund had to suspend payments. The sudden impact on the availability of business credit in the midst of the broader financial crisis compelled the Treasury and Federal Reserve to provide hundreds of billions of dollars by resorting to highly unorthodox emergency funds to maintain the functioning of markets.

The time has clearly come to harness money market funds in a manner that recognizes both their structural importance in diverting funds from regulated banks and their destabilizing potential. If indeed they wish to continue to provide on so large a scale a service that mimics commercial bank demand deposits, then strong capital requirements, official insurance protection, and stronger official surveillance of investment practices is called for. Simpler and more appropriately, they should be treated as an ordinary mutual funds, with redemption value reflecting day by day market price fluctuations.

I call your attention to another piece of unfinished business. It should be simpler because it has already been passed into law: specifically a member of the Federal Reserve Board should be designated as Vice Chairman for Supervision. Supervision of the banking and financial system should have a strong and visible place on the agenda at the Federal Reserve. It should have a proper focus in Congressional oversight. That the position remains unfilled, two years after its authorization and in the midst of financial uncertainty, is a mystery to me.