STATEMENT OF PAUL A. VOLCKER
BEFORE THE
JOINT ECONOMIC COMMITTEE
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Mr. Chairman and members of the Joint Economic Committee:

I appreciate the opportunity to discuss informally some implications of the systemic risks in the financial system as revealed in the current crisis. This statement will simply point out some of the more important and unresolved issues as I see them. The complications are evident. There are no quick and facile answers. Your deliberations can, however, help lay the groundwork for legislation that will, I believe, be necessary, if not now in the midst of crisis and an election campaign, then in 2009.

The background for the crisis and for any official and legislative response is the rather profound change in the locus and nature of financial intermediation over the past couple of decades. We have moved from a heavily regulated and protected commercial bank dominated world to a more open market system, with individual credits packaged and repackaged and traded in impersonal markets. Large commercial banks have themselves taken on important characteristics of investment banks, but the investment banks and hedge funds that have come to dominate the trading, if regulated at all, have not been closely supervised with respect to their safety and soundness.

The new “system” has, indeed, been heavily “engineered”, with highly talented, well paid, and mathematically sophisticated individuals dissecting and combining credits in a manner designed to diffuse risk and to encourage an allocation of those risks to those most able to handle them.

The result in practice has been enormous complexity, and with the complexity has come an opaqueness. In the process, close examination of particular credits with respect to risk has too often been lost; the sub-prime mortgage is only the leading case at point.

The complexity has also made it more difficult to assess risk for the managers of particular large institutions, for supervisors and for credit rating agencies alike. The new system seemed to work effectively in fair financial weather, with great confidence in its efficiency and presumed benefits. However, I believe there is no escape from the conclusion that, faced with the kind of recurrent strains and pressures typical of free financial markets, the new system has failed the test of maintaining reasonable stability and fluidity.

One broad lesson, it seems to me, is the limitations of financial engineering, involving presumably sophisticated modeling of past market behavior and probabilities of default. It's not simply a matter of inexperience or technical failures in data selection or the choice of relevant time periods for analysis. The underlying problem, I believe, is that mathematic modeling, imbued with the concept of normal frequency distributions found in physical phenomena, cannot easily take account of the human element of markets -- the episodes of contagious "irrational exuberance" or conversely "unreasoned despair" that characterize extreme financial disturbance.

It is recognition of those extreme and unsettling market disturbances that conceptually has justified official intervention in free markets. That intervention has taken the form of regulation and supervision and of providing an official "safety net" for systemically important institutions, in the past almost entirely limited to commercial banks and traditional thrift institutions.

Faced with the evident threat of a potential cascading breakdown of an already heavily strained financial institution, the Federal Reserve, drawing upon long dormant emergency powers, recently felt it necessary to extend that safety net, first by providing direct support for one important investment bank experiencing a devastating run, and then potentially extending such support to other investment banks that appeared vulnerable speculative attack.

Whatever claims might be made about the uniqueness of current circumstances, it seems inevitable that the nature of the Fed’s response will be taken into account and be anticipated, by officials and market participants alike, in similar future circumstances. Hence, the natural corollary is that systemically important investment banking institutions should be regulated and supervised along at least the basic lines appropriate for commercial banks that they closely resemble in key respects.

Several issues now need to be resolved by legislation or otherwise.

Just how far should the logic of regulation and supervision be extended? To all “investment banks” and what is an accepted definition of an investment bank? What about to “hedge funds” of which I am told there are some fifty thousand around the world? Presumably very few of them could reasonably meet the test of systemic importance. However, a few years ago, a single large, widely admired, heavily “engineered“ hedge fund suddenly came under market pressure and was judged to require assistance by the Federal Reserve in the form, not of overt official financial assistance, but of moral suasion among its creditors.

Recent events raise another significant question for central banking. Given the strong pressures and the immobility of the mortgage markets – pressures spreading well beyond the sub-prime sector -- central banks in the United States and elsewhere have directly or indirectly intervened in a large scale in those markets. That approach departs from time-honored central bank practices of limiting lending or direct purchases of securities to government obligations or to strong highly rated commercial loans. Apart from any consequent risk of loss, intervention in a broad range of credit market instruments may imply official support for a particular sector of the market or of the economy. Questions of appropriate public policy may in turn be raised, going beyond the usual remit of central banks, which are typically provided a high degree of insulation from political pressures.

That independence is integral to the central responsibility of the Federal Reserve (and other central banks) for the conduct of monetary policy.

The Federal Reserve also has in practice, and enshrined in is founding mandate, certain responsibilities for commercial banking supervision. In practice, it has in my mind been properly considered as “primus inter pares” among the various financial regulators.

In my view, a continuing strong role in banking regulation and supervision by the Fed has been important for at least three reasons. First, as the “lender of last resort” and the ultimate provider of financial liquidity, if should be intimately aware of conditions in the banking system generally and of particular institutions within it, a precondition for decisions with respect to financial or other assistance.

Second, the widely understood and accepted independence of the central bank provides strong protection from the narrow political pressures that may be brought to bear in the exercise of regulatory responsibilities.

Third, the broad responsibilities of the Federal Reserve to encourage orderly growth seem to me to encourage an even-handedness over time in its approach toward regulation.

I have long thought the Federal Reserve lead role in banking (and financial) supervision should be recognized more clearly than in present law. Experience over time, reinforced by recent events, also strongly suggests that if that Federal Reserve role is to be maintained and strengthened, important changes will be necessary in its internal organization. Specifically, direct and clear administrative responsibility should lie with a senior official, designated by law. Stronger staff resources, adequately compensated, will be necessary.

I recognize that, if supervisory and regulatory responsibilities are to extend well beyond the world of commercial banking and its holding companies, then a more fundamental question will need to be faced. Should such a large responsibility be vested in a single organization, and should that organization reasonably be in the Federal Reserve without risking dilution of its independence and central bank monetary responsibilities?

Clearly, other large questions are exposed by the present financial crisis. The role and organization of credit rating agencies, the use and mis-use of mark-to-market and “fair value” accounting, the oversight of hedge funds, and somewhat removed but nonetheless important, the growing role of sovereign wealth funds, all need consideration.

More generally, I must emphasize that little of the needed changes and reforms can proceed independently, without consideration of, and a high degree of cooperation with, other leading financial powers, especially the European Union and Japan. In a world of globalized finance, recent experience demonstrates we are all in this together. Idiosyncratic national approaches simply cannot be fully effective, and can easily be counter-productive of needed discipline.

Recent years have brought encouraging progress in a number of important areas: bank capital requirements, common accounting standards, growing consistency in auditing and settlement procedures and elsewhere. It is those areas of intergovernmental, private, and public – private initiative upon which we need to build. The critical pressures on our financial markets are not unique, nor can an approach to dealing with those pressures be successful in isolation. We have a lot upon which to build, and we should not miss the opportunity to extend the areas of cooperation.