STATEMENT
OF
PAUL A. VOLCKER
BEFORE
THE U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES
WASHINGTON, DC
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Mr. Chairman, Members of the Committee:

I appreciate your invitation to address important questions concerning the link between monetary policy and Federal Reserve responsibilities for the supervision and regulation of financial institutions. Those questions are particularly relevant in the light of the recent breakdown in our financial markets and the important role of the Fed as the crisis developed and in dealing with its consequences.

However timely this hearing, I want to emphasize the issues posed are not new. The latest crisis – frequently cited as a once in a generation or even once in a century affair – has had a devastating effect. It is, however, only the latest of a string of financial disturbances that seem to have been growing in both intensity and frequency. Plainly, we should learn from this experience, drawing appropriate conclusions about the role and responsibilities of the Federal Reserve. That institution, I think it is fair to say, has been generally viewed as the principal, if far from the only, Federal financial regulator and supervisor.

Before addressing the specific questions you have posed, I should make clear my long-held view – a view developed and sustained by years of experience in the Treasury, in the Federal Reserve and in private finance. Monetary policy and concerns about the structure and condition of banks and the financial system more generally are inextricably intertwined. Other agencies, certainly including the Treasury, have legitimate interests in regulatory policy. But I do insist that neither monetary policy nor the financial system will be well served if our central bank is deprived from interest in, and influence over, the structure and performance of the financial system.

Today, conceptual and practical concerns about the extent, the frequency, and the repercussions of economic and financial speculative excesses have come to occupy our attention. If so-called “bubbles” are indeed potentially disruptive of economic activity, then important and interrelated questions arise for both monetary and supervisory policies. Judgment is required about if and when an official response – some form of intervention - is warranted. If so, is there a role for monetary policy, for regulatory actions, or both? How can those judgments and responses be coordinated and implemented in real time – in the midst of crisis in a matter of days?

The practical fact is that the Federal Reserve must be involved in those judgments and that decision-making. Beyond its broad responsibility for monetary policy and its influence on interest rates, it is the agency that has the relevant technical experience growing out of working in the financial markets virtually every day. As potential lender of last resort, the Fed must be familiar with the condition of those to whom it lends. It oversees and participates in the basic payments system, domestically and internationally.

In sum, there is no other official institution that has the breadth of institutional knowledge, the expertise, and the experience to identify market and institutional vulnerabilities. It also has the capability to act on very short notice. And the Federal Reserve after all, is the only agency that has financial resources at hand in amounts capable of emergency response.

More broadly, I believe the experience demonstrates conclusively that the responsibilities of the Federal Reserve with respect to maintaining economic and financial stability require close attention to matters beyond the specific confines of “monetary policy”, if narrowly defined as influencing monetary aggregates and short-term interest rates. For instance, one recurring challenge in the conduct of monetary policy is to take account of the attitudes and approaches of banking supervisors as they act to stimulate or restrain bank lending, and to adjust capital standards of financial institutions.

The need to keep abreast of rapidly developing activity in other financial markets, certainly including the markets for mortgages and derivatives, has been driven home by the recent crisis.

None of this, to my mind, suggests a need for regulatory and supervisory authority to lie exclusively in the Federal Reserve. There may be advantages in some division of responsibilities. A simple regulator may be excessively rigid and insensitive to market developments. But equally clearly we do not want competition in laxity among regulators aligned with particular constituencies or exposed to narrow political pressures.

We are all familiar, in the light of all that has happened, with weaknesses in supervisory oversight, with failures to respond to financial excesses in a timely way, and with gaps in authority. Those failings spread in one way or another among all the relevant agencies, not excepting the Federal Reserve. Both law and practice need reform. But, however those issues are resolved, I do believe the Federal Reserve, our central bank, with the broadest economic responsibilities, with a perceived mandate for maintaining financial stability, with the strongest insulation against special political or industry pressures, must maintain a significant presence with real authority in regulatory and supervisory matters.

Against that background, I will respond to the particular points you raised in your invitation.

I believe it is apparent that regulatory arbitrage and the fragmentary nature of our regulatory system did contribute to the nature and extent of the financial crisis.

That crisis exploded with a vengeance outside the banking system, involving investment banks, the world's largest insurance company and Government – sponsored agencies. Regulatory and supervisory agencies were neither reasonably equipped nor conscious of the extent of their responsibilities. Money market funds growing over several decades, are essentially a pure manifestation of regulatory arbitrage. Attracting little supervisory attention they broke down under pressure, a point of significant systemic weakness. The remarkable rise of the sub-prime mortgage market developed through a variety of channels, some without official oversight. There are large questions about the role and supervision of the two hybrid public/private organizations that came to dominate the largest of all our capital markets, that for residential mortgages.

Undeniably, in hindsight there were weaknesses and gaps in the supervision of well-established financial institutions, including banking institutions, major parts of which the Federal Reserved carries direct responsibility. Some of those weaknesses might have been – should have been - closed by more aggressive regulatory approaches. But some gaps in effective supervision – institutions owning individual banks or small thrifts were loopholes explicitly permitted by legislation.

As implied by my earlier comments, the Federal Reserve, by the nature of its core responsibilities, is thrust into direct operational contact with financial institutions and markets. Beyond those contacts, the twelve Federal Reserve Banks exercising supervisory responsibilities provide a window into both banking developments and economic tendencies in all regions of the country.

In more ordinary circumstances, intelligence gleaned on the ground about banking attitudes and trends will supplement and color forecasts and judgments emerging from other indicators of economic activity. When the issue is timely identification of highly speculative and destabilizing bubbles – a matter that is both important and difficult – then there are implications for both monetary and supervisory policy.

Finally, the Committee has asked about the potential impact of stripping the Federal Reserve of direct supervisory and regulatory power over banks and other financial institutions, and whether something can be learned about the practices of other nations. Those are not matters that permit categorical answers, good for all time.

International experience varies. Most countries maintain a position – often a strong position - for central banks on financial supervision. In some countries, there has been a formal separation. At the extreme, and contrary to earlier approaches, all formal supervisory and regulatory authority over financial institutions was consolidated in the U.K. into one authority, with rather loose consultative links to the central bank. The approach was considered attractive as a more efficient arrangement, avoiding both agency rivalries and gaps of inconsistencies in approach.

The sudden pressures of the developing crisis revealed a problem in coordinating between the agency responsible for supervision, the central bank which needed to take action, and the Treasury. The Bank of England had to consider intervention with financial support without close and confident appraisals of the vulnerability of affected institutions. As a result, I believe the U.K. government is reviewing the need to modify the present arrangement.

For reasons that I discussed earlier, I do believe it would be a really grievous mistake to insulate the Federal Reserve from direct supervision of systemically important financial institutions. Something important, if less obvious would also be lost if the present limited responsibilities for smaller member banks were to be ended. The Fed’s regional roots would be weaker and a useful source of information lost.

I conclude with one further thought. In debating regulatory arrangements and responsibilities appropriate for our national markets, we should not lose sight of the implications for the role of the United States in what is, in fact, a global financial system. We necessarily must work with other nations and their financial authorities. The United States should and does still have substantial influence in those matters including agreement on essential elements of regulatory and supervisory policies. It is the Federal Reserve, as much as and sometimes even more than the Treasury, that carries a special weight in reaching the necessary understandings. That is a matter of tradition, of experience and of the perceived competence and authority of our central bank. There is a sense of respect and confidence right around the world – matter that cannot be prescribed by law or easily replaced.

Clearly, changes need to be made in the status quo. That is certainly true within the Federal Reserve. I believe regulatory responsibilities should be more clearly focused and supported. The crisis has revealed need for change within other agencies as well. Consideration of broader reorganization of the regulatory and supervisory arrangements is timely.

At the same time, I urge in your deliberations that you recognize what would be lost – lost not just in the safety and soundness of our national financial system but in influencing and shaping the global system – if the Federal Reserve were to be stripped of its regulatory and supervisory responsibilities and be no longer recognized here and abroad as “primus inter pares” among the agencies concerned with the safety and soundness of our financial institutions. Let us instead strengthen what needs to be strengthened, and demand the high levels of competence and performance that for the too long we have taken for granted.