PAUL A. VOLCKER REMARKS AT FEDERAL RESERVE BANK OF CHICAGO 13TH ANNUAL INTERNATIONAL BANKING CONFERENCE CHICAGO, SEPTEMBER 24, 2010

This Conference is designed to cast light on an important subject: how do we collectively better assure our capacity y to protect the stability of financial markets that have become highly sophisticated, complex, increasingly global, but by the evidence also opaque and exceedingly fragile.

It is a challenge for the United States. We are a country with a variety of overlapping regulatory and supervisory agencies that nonetheless have serious gaps in oversight and regulatory authority. It is a still broader challenge given the international integration of markets, and the differing regulatory traditions and authorities.

So how do we deal with the challenge?

"Macro-Prudential Regulation" is one concept set forth in this Conference.

I will confess that I am not really comfortable with that nomenclature. I suppose there is some analogy with "micro" and "macro" economics, a distinction that itself can be challenged theoretically. As a practical matter, macro-economics has not coherent and generally accepted doctrine. In the midst of economic crisis, conflicting approaches are strongly advanced.

Does "macro-prudential regulation" suggest some agency will have authority to not only oversee financial markets and all significant financial institutions but also establish and enforce particular rules for "hands-on" banking and securities regulators? If so, what role is left for existing, more specialized, and independent regulatory agencies including central banks? How do the existing institutions for international coordination - specifically those at Basle responsible for bank capital standards, fit into the picture?

The Group of Thirty will shortly issue a report that hopefully will help cast light on some of these issues. Interesting enough, the authors spent some time defining just what is meant by a macro-prudential approach. They settled on the term "macro-prudential policy", a broad, but seemingly less specific role for the new oversight body than "regulation".

Certainly, whatever the precise semantics, there is a felt need for an approach toward oversight and regulation that goes beyond concerns about particular markets and particular institutions. The financial crisis has conclusively demonstrated that existing regulatory approaches focused on particular institutions and markets failed to appreciate the rapid growth of new markets and new financing techniques. Those typically highly engineered and opaque approaches turned out to have most serious implications for the safety and stability of the system as a whole. Arguably, even if the risks had been recognized, there was a lack of regulatory and supervisory tools and approaches, nationally or internationally, adequate to deal effectively with the potential problems.

In essence, there was a regulatory lacuna - no institution or institutions that recognized a responsibility for surveillance and oversight of the financial system as a whole. The increasingly close interdependencies in a heavily engineered world of securitization and derivatives escaped full understanding. Altogether, developments that should have raised critical questions for the stability of the system - most obviously the rapid rise of subprime mortgages and credit default swaps - were, if not entirely unnoticed, poorly understood and essentially uncontrolled. Ironically, those developments were, in fact, greeted by most market participants and a number of regulators as contributors to market efficiency and stability.

Naively, I have thought that central banks, whether or not explicitly charged with surveillance of financial markets, typically recognized that their broad official responsibilities for monetary policy, as lender of last resort and for regulating the banking system, implied concern with the structure and performance of financial markets generally.

What has happened, is that commercial banks, the natural counterparts and constituency of central banks, have become less dominant in financial markets, most particularly in the United States and the United Kingdom. The major banks have morphed into such large and diversified institutions as to be considered beyond risk of failure. At the same time, there were intellectual currents in central banks, in markets, and in academia that have played a part in what in retrospect appears to have been regulatory inattention.

Central banks had learned the central importance of maintaining price stability - a good thing. At the same time, as the risks of inflation subsided, the thought that markets could flourish without intrusive regulation became compelling. After all, markets were highly efficient, able to reallocate risk in a manner that would diffuse the damage of isolated failures without systemic damage. By adroit adjustment in monetary policy in a context of price stability, financial strains associated with economic cycles or occasional incidents of "irrational exuberance" could be managed effectively by means of interest rate adjustments.

In essence, the failure to adequately foresee the growing possibility of a full blown financial crisis, and to take measures to deal with that possibility was both institutional and intellectual.

Looking back at the origin of the financial crisis, I do not join the school of thought that attaches the central responsibility to monetary policy. Rather, in my judgment, it is the prolonged disequilibrium in the world economy, the diverse and ultimately unsustainable patterns of consumption and savings in the United States and some other countries, growing imbalances in international trade and payments, and finally dangerous excesses in housing markets that account for the severity of the recession and the elated financial turmoil.

The fact is that those imbalances and speculative excesses were facilitated and extended by innovations in finance. The persuasive rise of securitization, with all its complexity and opaqueness, the sense that hedging and derivatives could successfully contain and diffuse risk, the widely hailed fluidity and liquidity of markets, all these contributed to ease the borrowing, the high leverage, and the truly unprecedented levels of debt that made the markets so vulnerable and recovery so difficult.

There are those who suggest that, in the wake of crisis, the enormous losses for some, and the uncertainties that remain, institutions and markets have been chastened by experience. The excesses and weaknesses are being self-corrected. Certainly, there is some truth in those observations. But we also see signs of longing -- and not just longing - for pre-crisis patterns, with its rewards of extraordinary profits and compensation from risk-taking. We also know from experience that memories may be short when large rewards are at stake. Hence, the strong need for basic reforms of financial markets.

In approaching the needed reform, we should not be beguiled by thinking that we are dealing with so sensitive and efficient financial mechanism that somehow economic growth will be placed at risk by sensible and needed regulatory intervention, including, for instance, higher capital requirements and more conservative leveraging. To the contrary, to the extent that the complexity, the opacity, the ultimate fragility of financial markets has contributed to the depth and extent of the recession and its aftermath of unemployment and slow recovery, the need for new regulatory approaches is clear.

This is all a long way around for me to emphasize the importance of this Conference, and the others to come, in sorting out one key element in the total reform effort. Governments nationally and internationally have to find ways and means for maintaining surveillance of financial markets as a whole, recognizing all the interconnections and innovations, encouraging prudent practices and dealing with pockets of fragility, present or emerging.

The minimal requirement is one of broad oversight of the entirety of financial markets, developing, collecting, and appraising statistical and other information. New institutional developments and financial instruments need to be monitored and evaluated. To the extent critical weaknesses are exposed, alarm bells should ring.

All of that, to me, comes under the general rubric of oversight. It has implications for regulation, but does not itself necessarily imply regulatory authority - hence my reservation about the term "macro-prudential regulation". In any case, resolving the way the surveillance and oversight responsibilities should relate to specific regulatory agencies and practices will likely be resolved differently by different countries with their particular regulatory traditions and institutions.

The approach adopted by the United States in the Dodd/Frank legislation takes one possible approach toward reconciling the regulatory implications of integrating regulatory approaches. A new Federal Stability Oversight Council (FSOC) has been established, essentially bringing together heads of ten existing regulatory agencies. The Secretary of the Treasury will act as chair. To service the Council, a new office of Financial Research in the Treasury will collect and analyze relevant data. Areas of systemic risk will be brought to the Council's attention.

That much is clear. A workable relationship between the Council and the individual regulatory agencies will need to develop over time. As set out in law, it is the Council that directs or approves certain specifics - such as which institutions may be considered systemically important. In some instances, general standards for capital and leverage might be established. But we will have to wait and see how those authorities complement or compete with the power of agencies responsible for "hands-on" supervision".

What is clear is that in practice, the Federal Reserve will retain a key role in regulating and supervising "systemically important" banking organizations and designated non-bank financial institutions. In fact, the range of its authority has been broadened.

Overall, the arrangements may appear rather cumbersome - a reflection of the long American predilection to retain a number of overlapping agencies. My sense is that it is likely, and appropriate, that the Federal Reserve will retain a key role - potentially stronger than in the past. That prospect is reinforced by the designation by law of one member of the Federal Reserve Board as a new Vice Chairman charged with specific responsibility for supervision. Such an appointment, by the President and confirmed by the Senate, should provide a focus that has been at times lacking in the past with respect to banking supervision.

The events of recent years have reinforced the importance of a close relationship between regulatory and supervisory concerns and monetary policy. There may be legitimate debate about the contribution that monetary policy may have made to excessive risk-taking and to the housing bubble that have provided the tinder for the financial firestorm. There cannot now be any real question about the importance of the central bank being alert to such potentially destabilizing developments. It should be able to respond with adequate supervisory and regulatory authorities to complement its monetary responsibilities.

In the end, whatever the precise administrative arrangements for surveillance and macro-prudential supervision, a large degree of judgment by the relevant authorities will be necessary. To me, however, experience strongly suggests that judgment, however indispensable, needs to be supported by appropriate structural arrangements.

Several areas stand out in that respect.

- Derivatives should to the maximum extent workable should be forced into clearing houses or other settlement arrangements providing greater transparency, commonality and assured methods of meeting obligations.
- Some supervisory authority does need to be extended to "systemically important" non-bank institutions, but I do believe

they should not benefit from access to lender of last resort facilities, or liability insurance. Bringing them within the official safety net would only reinforce expectations of assistance in time of crisis.

- To make ~~that~~ The approach of no "bailout" feasible and credible, there is a need for an efficient "resolution authority". In effect, a specified agency should be in a position to facilitate liquidation of even important non-bank institutions on the brink of failure.

- Complementary to that approach, it seems to me both analytically appropriate and politically understandable that commercial banks with access to the official safety net not be permitted to engage in essentially speculative proprietary activities.

In addition to the arrangements for broad financial market surveillance, all of these points, are in one way or another included in the American legislation. Plainly, there are other areas that need structural reform that have for one reason or another been left unsettled in the United States or elsewhere. By far, the most important of these areas involves the largest part of the American capital market – that for the residential mortgages. It was, or course, the rapid rise in the sub-prime mortgage that provided the tinder for the financial fire.

Today, that market is essentially run by the United States government by means of its take over of Fannie Mae and Freddy Mac and by the Federal insuring authorities. There is no ready made, practical alternative. But clearly developing a new framework for an efficient private mortgage market is a matter of first priority.

What is clear now, is that the kind of detailed issues raised in this Conference are relevant for the United States and for all developed markets. You meet at a critical time. There is a clear consensus on a broad approach toward oversight of financial markets. Moving from consensus to operational success is the challenge and that is where your contribution is needed.