

MAIS LECTURE
DELIVERED BY
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LONDON - JULY 14, 2011

The World of Finance and the Public Interest

Spending even a few days in London is always a special pleasure. This occasion brings back memories of my own student days at a different academic institution close to this place. I was learning about the world of finance in an environment that emphasized some long-treasured traditions. Now, 60 years later, I am honored by the invitation to deliver the Mais Lecture sponsored by a relatively young Cass Business School directed toward training practitioners in a much more complex world of international finance.

It is a world with instruments literally unknown in the 1950's and 60's. Credit default swaps, CDOs squared or not, interest rate swaps, securitization extending to all sorts of assets, the application of sophisticated mathematical techniques to financial markets, all these and much more are modern inventions. They have generated an enormous amount of activity. Commercial banks, which to my mind are still the indispensable heart and soul of the financial system, face competition from other less regulated and more entrepreneurial institutions often at the cutting edge of innovation.

It is also a world in which financial markets have become truly international. Few industrialized countries these days dare attempt substantial prohibitions on the flow of capital. The larger firms operate in multiple international markets.

Then, in a matter of a few weeks in 2008, the world of modern finance came tumbling down. Massive official support by central banks and treasuries acting well beyond established precedents were required to contain the powerful recessionary forces inherent in the financial

breakdown. In the process, major independent investment banks and other financial institutions that had come to dominate international markets simply merged or disappeared. The few remaining were forced to seek commercial banking licenses, providing resort to central bank liquidity support in time of need and the comfort of deposit insurance.

All of this has left in its wake basic questions of market organization. What are the appropriate limits to government intervention? Has the expectation of future official intervention and "bailouts" so distorted market incentives that the basic philosophy of competitive free markets has been undermined? More broadly, what is the proper role of official international institutions and agreements in dealing with markets that are beyond the control of national authorities?

In the aftermath of the crisis, public opinion and official thinking rightly coalesced around the need for thorough-going reform. That was never going to be satisfied by quick and easily agreed upon approaches. Conceptual uncertainties, technical complexities, the need for international consistency, and not least politically powerful industry interests resistant to change have all slowed responses. The passage of time has tended to dull a sense of urgency. More time for study, fear of unintended consequences or stifling innovation, concerns that uncertainties of reform will impede economic recovery are all set out as reasons, valid or not, to call a halt, or to go slowly, slowly to the point of ineffectiveness.

Consider where we have been and where we are. We live in a world in which London and New York - and in other financial centers as well - enormous fortunes were won in the new financial markets. Those fortunes have run far beyond any reasonable expectations a decade or two ago. But those personal gains have not been reflected in any benefits visible to the naked eye, or even to professional analysis, in exceptional growth in national productivity or in gains in income for average workers in the United States or in the United Kingdom. National income distribution in the United States and elsewhere has been skewed to a socially questionable extent. When we count in the enormous economic losses consequent to the collapse of the financial system, the case for pressing forward with thoroughgoing reform should be uncontested.

Take the telltale signs in the daily press of troublesome market practices emerging even after the crisis. Lapses in ethical practices in designing and selling so-called structural products; conflicts of interest inherent in diversified organizations dealing with customers and proprietary accounts in various guises; breaches of accounting conventions; flagrant examples of insider trading, infecting even highly placed market leaders; compensation practices continuing to flout reasonable restraint: these all raise a question as to whether caveat emptor has not become the all encompassing ruling moral code.

Right now in Europe, the complexities, the cross-border implications, and the interconnectiveness of European finance confirm that we are a long way from a resilient financial system with robust defenses against cascading failures.

So, where do we stand? Where has progress been made and where are the key needs?

I want to touch upon three interrelated areas. Each of these areas requires reform cutting reform across the traditional reach of national regulatory authority and even encroach upon sovereignty.

The first of these areas concerns bank capital and liquidity, matters about which national regulatory agencies have long recognized, in principle, the need for international consistency.

Stronger capital standards for banks are obvious and important matters and the established Basle Committees provide ready-made fora. Detailed and useful recommendations have been made.

I am among those who accept that the new proposed Basle III standards for banks do represent progress. For one thing, the approach of reinforcing the risk-based capital standards with overall leverage limits represents conceptual progress in dealing with the weaknesses of the past standards.

I do not, however, believe that bank capital standards, and extending those standards to other

"systemically significant" financial institutions can carry almost single-handedly the full load of reform as some have argued. Banks are understandably sensitive to being placed at a competitive disadvantage internationally or against competing non-bank institutions. There are, in fact, practical limits in the extent to which high capital requirements can be applied consistent with the sustained profitability of conservatively managed commercial banks. While those problems can be ameliorated by applying competitively appropriate capital standards to other systemically important financial institutions, as will be required by law in the United States, equally difficult "boundary" questions arise. What, for instance, is the precise definition of "systemically significant?"

The administrative difficulty lies in the certainty that strong and uniform administration of capital standards in different countries, or even within a specific country with competing regulatory interests, will be difficult to maintain. Supervisory judgments concerning risk and other factors are matters of fallible judgment. Market and institutional ingenuity will find ways to mitigate the impact of agreed standards. The lobbying pressures to make exceptions, to weaken standards, to threaten campaign contributions, are simply facts of life in our democracies, carrying the risk of competition in laxity.

The practical weaknesses in any regime of capital standards strong enough to be fail safe lead me to my second area of concern. True reform will require structural change, change that requires altering business practices, management incentives, and institutional responsibilities.

In approaching this challenge, there is a sense of conceptual agreement among a number of national and regional authorities. But in practice, important elements of an operational consensus are missing and progress is slow.

Consider some important areas that have been proceeding on their own timetable concurrent with, but largely independent of, reforms that have occupied the attention of financial authorities.

After a decade of concerted effort, acceptance internationally of uniform high quality accounting

standards set by the International Accounting Standards Board is close to becoming reality. International standards are already in place, or agreed, by well over 100 countries, including Europe and notably important emerging business and financial centers.

The major remaining challenge to achieve full consensus is for the United States - and specifically for the Securities and Exchange Commission - to accept international standards, first as an option and ultimately as a requirement for American-listed companies. For several years, the IASB and the American FASB have been working to achieve convergence on workable standards. The time is ripe for action.

The significance of this effort lies not only in the simplification and savings implicit in common standards for companies operating internationally. Greater confidence in the quality and enforcement of the standards is central to the effort.

One key element in delaying consensus has been the appropriate application of "fair value" accounting rules for commercial banks and other financial institutions. "Marking to market" for institutions actively engaged in trading and dealing in securities and other obligations with well-defined and developed markets is entirely appropriate. For commercial banks and others committed to relationship lending and long-term holdings, other approaches are more appropriate, a conclusion reinforced in deeply unsettled market conditions with limited trading activity and no clearly representative pricing.

International and national standard setters seem to be moving toward an agreed understanding of the problems associated with rigid fair value accounting in the midst of crisis, and a reasonable common approach appears within grasp.

A related, but too often neglected area, concerns the discipline of auditing firms themselves in interpreting and vigorously applying accounting standards as they review the financial statements of their clients.

The Sarbanes/Oxley legislation in the United States, enacted following the Enron and other accounting scandals early in the century, provides a vehicle for better

enforcement in the United States - the Public Company Accounting Oversight Board. The policies of that Board, given its oversight of the major accounting firms headquartered in the United States, potentially can have substantial influence over international auditing practice. I am encouraged by the sense that the leadership of the PCAOB is today aware of the need to reinforce the sense of "independence and skepticism" which is key to successful auditing, words recently set out by the new PCAOB Chairman. He points out conflicts of interest, failure to be alert to the possibility of a fraud, and compensation practices within the firm that reward cross selling of services by auditing partners all impact an approach of active surveillance by auditors.

Given the extreme lapses in analytic judgment and the ratings of securitized mortgages, the role and practices of credit rating agencies have been a matter of concern internationally. So far, I am not aware of a satisfactory approach to promote a consistent supervisory approach or more fundamental changes to the industry. There are, however, some indications that experimentation is underway, whether by new regulation or simply by means of encouraging competitive pressure by more specialized firms with different models of compensation. What is in any event clear, lenders and investors should not neglect the need to develop their own credit standards and discipline.

The larger conceptual issues revolve around the structure of commercial banks themselves, including their size, their range of functions, and the extent to which they can be or should continue to be distinguished by regulation and official support from other large financial institutions. A key aspect of those considerations is dealing with the sense of "too big to fail" and the related moral hazard. Beyond the technical issues, the understandable taxpayer frustration in being called upon to "bail out" dominant and richly rewarded firms with public money demands a response.

In recent years, aided and abetted by decisions forced in the midst of crises, there has been a remarkable concentration of banking resources in virtually every major market. I, along with many others, feel uncomfortable with the spread of the largest institutions, paralleled by the relative decline of smaller community-based or regional banks. Specifying a limit on size relative to GDP or other

relevant measure, and prohibiting growth beyond that point by merger or acquisition, is a rather modest and useful approach, but it does not deal at all effectively with existing reality. However, it is difficult to make a really compelling case (practically and politically) for simply breaking apart existing institutions, leaving intact the present conglomeration of functions and services that have contributed to the crisis.

At present, while the matter is still under discussion, the U.K. is considering a different, and seemingly more sweeping, structural approach. A "retail bank" would be "ring fenced" within a holding company structure of a larger and more diversified banking or financial organization.

Critical details are lacking. Just what is to be defined as retail on either side of the balance sheet? What if any transactions can be contemplated among the segregated parts of the holding company? Are there to be restraints on the allocation of capital within the holding company? Will the governing structures overlap? And so on.

The object, if I understand it, is to protect the integrity of the retail bank dealing with individuals (and "small" businesses?), with the implication of full government support by way of deposit insurance and access to the central bank for liquidity. Interaction with the holding company and its other affiliates would be limited or prohibited, but the extent to which the "wholesale" financial organization would still be empowered to accept deposits, manage the payments system, and have access to a government "safety net" is not at all clear. Depending on how those decisions are made, the question will inevitably arise as to the financial and regulatory logic of maintaining a "retail bank" as part of what in most cases would appear a much larger highly diversified and "systemically significant" organization.

In any event, the nagging overriding question will still arise: how to deal with the imminent or actual failure of such large, systemically significant, financial institution whether or not it is a "bank".

One approach is embedded in the Dodd/Frank legislation in the United States. It calls for a "resolution authority" empowered to intervene and provide resources to deal with

the settlement of certain pressing claims. The failed institution should not, however, survive with stockholders in place, or management intact. Unsecured creditors would be at risk.

Conceptually, that approach embodies essential elements in what appears to be a broad consensus among national regulatory authorities. That broad intellectual consensus needs to be practically implemented in the face of complicated jurisdictional, legal and administrative considerations. In essence, established national procedures for dealing with insolvency would be superseded for certain financial institutions in crisis.

One thing is certain. Incipient failure of large banks - retail or whole sale - in the midst of crisis will have consequences internationally. I am aware that continuing discussions are taking place among the relevant authorities to clarify and delineate mutual responsibilities and approaches. But there is a long distance to go.

One important element in a consensus approach involves the idea of a "living will". A financial institution will be required to identify to the satisfaction of its regulatory authorities elements of its organization that could reasonably be separated, merged, sold or liquidated in the face of imminent or actual failure. Again, there are large organizational questions. It is not just a question of which businesses are easily separable parts of an existing institution, but which are most vulnerable to crisis and are dependent on the relationship to the holding company.

A rather different but in some ways complementary approach toward banking structure has been taken by the United States. Commercial banking organizations will be prohibited from proprietary trading. The sponsorship and investment in hedge and equity funds will be strictly limited. That approach does make a contribution toward limiting size and risk, as problems arising in hedge funds and trading in the heat of crisis amply reflected.

Commercial banks in virtually every country are protected by means of access to central bank financing and deposit insurance. They are protected because they provide essential public services - a payments system, a safe depository, and loans, particularly to smaller and medium

sized businesses for which there is no fully effective substitute. The inherent risks are and should be ameliorated by regulatory constraints and supervisory surveillance.

But it has become amply clear during the financial crisis that the government "safety net", providing access to central bank liquidity and support and deposit insurance, signals broader official concern with the firm's viability. Extending that sense of official support to essentially speculative activities to me is entirely inappropriate. No apparent public purpose is achieved; the profits, if any, accrue to management and the stockholders; in time of crisis, losses tend to fall back on the public and the taxpayer.

Relatively few banks - but they are the giants - are significantly impacted by these prohibitions. I quite understand they may well wish to continue the trading that potentially brings large personal and institutional rewards. That trading also inexorably brings into a commercial banking organization an inappropriate culture: pressure for short-term results, an opportunity for enormous compensation, and, an attitude of buyer beware, are at odds with a bank's traditional, and often publicly touted, dedication to customer relationships.

One further point. To my mind, bankers (or regulators) who contend they cannot distinguish in practice between a continuing patterns of proprietary trading and trading in response to established customer needs cannot be considered either serious or qualified bank managers, no matter how many lawyers and layers of financial manipulation are employed subvert the plain prohibition.

I have strongly advocated that the CEO and board of directors of commercial banks personally attest to their firms compliance with the legal restrictions, an approach that has been explicitly supported by the United States Treasury.

There are, of course, many other financial institutions ready, willing and able to carry out speculative activity, at their own risk, regularly making markets and sponsoring and managing equity and hedge funds. There should be no implication of government support of those institutions. In fact, in recognition of their

vulnerability, these organizations typically are organized as partnerships with more stable financial support.

There is one other structural element particularly important in the United States. So-called money market funds originated largely as a matter of regulatory arbitrage. Now operating under regulatory forbearance, they provide customers with payment for their funds on demand at "par". Essentially, they promise that a redemption value of \$1 a share will be maintained so long as the market valuation of assets remains within a limited range. The funds typically are invested short-term, but in a variety of private obligations and foreign securities as well as U.S. Government paper.

By the time of the financial crisis those funds held more than 4 trillion dollars, money that might otherwise have been lodged in commercial banks and available for lending to businesses without market access. In the past, valuation shortfalls were typically met by an injection of cash by sponsoring entities. But in the midst of crisis, the oldest and entirely independent fund could not maintain its value, constraining redemption of its shares and leading to a run on money market funds generally. The result was to aggravate greatly the panic element in the financial crisis. Only a massive pledging of Treasury funds (funds normally reserved for foreign exchange operations!) and exceptional crisis-justified purchases of commercial paper by the Federal Reserve, restored order.

The SEC is considering measures to more closely regulate and restrict money market fund investment activities. Potentially it could, and I believe should, simply require that the funds provide payment based on the market valuation of their assets, rather than par. In either approach, an important step would be taken to enhance the stability of the system and the role of commercial banks as the primary custodian of demand deposits and financial intermediary.

Capital requirements, leverage ratios, better discipline on derivatives, resolution authority, the so-called Volcker Rule or the Vickers Commission proposals - these set out the legal framework and the mechanics of financial regulation. Important as they may be, none of it can be really effective, really count for much, if the culture of institutions and of the market place is wrong

headed - wrong headed in the sense of too many failures of leadership, and specifically wrong headed in the sense of cutting corners in responding to the primacy attached to reporting favorable short-term results and really exorbitant compensation practices.

I recited some of the egregious evidence at the start of these remarks, but you don't have to listen to me. Simply read the seemingly ubiquitous headlines in the business press that raise serious questions about ethical questions in business practice, the failure of management to root out dubious practices and of directors to hold management responsible.

I know there are earnest efforts in some firms to re-examine and restrict practices that too often have led to conflicts of interest and to self-dealing - Goldman Sachs to its credit, has made its own effort public in a detailed special report. But I am still struck by the extent that, in the midst of the continuing damage of the financial crisis to economy activity, the attitude is expressed that it's time to get back to "normal": to resist new regulatory discipline for fear of impairing the markets, to devote time, attention, and great expense to lobbying and lawyering in the effort to devise or invent loopholes in laws and regulations.

The problems of sorting out the invisible conflicts in agency/principal relationships is not new, but surely it has become more acute in a world in which everyone is a soulless counterpart rather than a warm blooded customer, with the continuing relationship and fiduciary responsibilities that characterization as customer implies.

That is not a matter that can be successfully reconciled by laws and regulations - even though well publicized violations of criminal and civil cases should help. It is truly a societal problem, and a problem that demands government officials themselves, and most of all supervisors and regulators, be independent and in their person examples of integrity.

I could cite examples of companies, long established companies, that are sensitive to these matters, and genuinely and successfully have reconciled the interests of their stockholders, their employees and the markets in which they operate. But too often I am reminded how boards

of directors perceive their roles, and whether they fully understand that a natural tendency to support management cannot trump the responsibility to oversee the corporation's financial and ethical practices.

Given the setting for the lecture today, permit me to raise a question about the responsibilities of our leading schools of business, and the extent to which they can and should place their emphasis on matters beyond and above mathematical techniques, complex financial analysis, and intensive marketing approaches. What does it take in the 21st Century to provide the kind of leadership that, at the end of the day is necessary to reconcile the competitive realities of international finance with the public interest in the sustained functioning of markets and the efficient distribution of financial resources.

To put the point more specifically, our best business schools these days attract a large share of our best, our brightest, and our most ambitious young men and women. Those same institutions set themselves out as exemplars of market capitalism and the benefits that open markets and capitalism can and should bring to the body public.

Those schools, Cass among them, have some hard thinking to do. Their mission cannot be simply a training ground for ambitious and financially motivated specialists, removed from the interests of the larger society.

I'd like to think Lord Mais had something larger in mind when he set out the case for creating in London "a center of excellence in banking and finance". The world of finance need to be the servant of successful democratic, market-oriented societies. And that is a vision worthy of this great City and of Cass within it.

I appreciate the opportunity to be with you this afternoon.