

**PROHIBITING CERTAIN HIGH-RISK INVESTMENT  
ACTIVITIES BY BANKS AND BANK HOLDING  
COMPANIES**

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**HEARING**

BEFORE THE

**COMMITTEE ON  
BANKING, HOUSING, AND URBAN AFFAIRS  
UNITED STATES SENATE  
ONE HUNDRED ELEVENTH CONGRESS**

SECOND SESSION

ON

EXAMINING RECENT RESTRICTIONS PLACED ON COMMERCIAL BANKS  
AND BANK HOLDING COMPANIES' HIGH-RISK INVESTMENT ACTIVITIES

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FEBRUARY 2, 2010  
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# CONTENTS

TUESDAY, FEBRUARY 2, 2010

	Page
Opening statement of Chairman Dodd .....	1
Opening statements, comments, or prepared statement of:	
Senator Shelby .....	3
Senator Johnson .....	48
Senator Brown .....	48
<b>WITNESSES</b>	
Paul A. Volcker, Chairman, President's Economic Recovery Advisory Board ....	5
Prepared statement .....	49
Response to written questions of:	
Senator Bunning .....	57
Neal S. Wolin, Deputy Secretary, Department of the Treasury .....	8
Prepared statement .....	53
Response to written questions of:	
Senator Bennett .....	58
Senator Bunning .....	58
Senator Vitter .....	59
<b>ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD</b>	
<i>Gone Fishing: E. Gerald Corrigan and the Era of Managed Markets</i> , The Herbert Gold Society .....	61
<i>The Volcker Rule &amp; AIG: Hedge Funds and Prop Desks Are Not the Problem</i> , Christopher Whalen .....	68
Prepared Statement of The Financial Services Roundtable .....	71



# PROHIBITING CERTAIN HIGH-RISK INVESTMENT ACTIVITIES BY BANKS AND BANK HOLDING COMPANIES

TUESDAY, FEBRUARY 2, 2010

U.S. SENATE,  
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,  
*Washington, DC.*

The Committee met at 2:30 p.m. in room SD-538, Dirksen Senate Office Building, Senator Christopher J. Dodd, Chairman of the Committee, presiding.

## OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order, and let me welcome our very distinguished witnesses this afternoon and the audience who is here and my colleagues, and I am sure there will be more coming in. This is a little out of the ordinary. Normally hearings like this we conduct in the morning, but I know that Chairman Volcker had conflicts in the schedule, so we are very grateful to you, Mr. Chairman, for accommodating us this afternoon and meeting with us here. And Neal Wolin we always welcome back. He does a great job at the Department of the Treasury, and it is an honor to have you here as well.

As many of you may know, we are going to have a hearing on Thursday as well to follow up and hear from industry and other people talk about these ideas that have been proposed by the Administration, particularly by Chairman Volcker. So we are grateful to you for being with us this afternoon.

What I will do is make a few brief opening comments myself. I will turn to Senator Shelby for any opening comments he may have, and then following what I now affectionately call the Corker rule, we will go right to our witnesses, unless some member here feels absolutely compelled to want to be heard before they are heard. Then we will accept any and all supporting documents and information you think would be worthwhile for the Committee to have. And then we will begin a line of questioning, and depending upon the number of people here, we will try and make enough time available so we have a thorough discussion of these ideas.

With that, today's hearing is entitled "Prohibiting High-Risk Investment Activities by Banks and Bank Holding Companies." And, again, Chairman Paul Volcker and Neal Wolin are here as our witnesses, so I thank all of you for joining us.

We meet today, as we have over these past number of months, in the shadow of a financial crisis that nearly toppled the American

economy. It is worth repeating again the cost of the greed and recklessness that brought us here. Over 7 million jobs in our country have been lost. The retirement plans of millions of Americans have been dashed. Trillions of dollars of household wealth and GDP are gone. And, obviously, all of us, regardless of what your political party is or affiliation, we cannot allow this to happen again.

The Obama administration has proposed bold steps to make the financial system less risky, and we welcome those ideas.

The first would prohibit banks or financial institutions that contain banks from owning, investing in, or sponsoring a hedge fund, a private equity fund, or any proprietary trading operation unrelated to serving its customers. The President of the United States has called this the Volcker rule, and today Chairman Paul Volcker himself will make the case for it. I strongly support this proposal. I think it has great merit.

The second would be a cap on the market share of liabilities for the largest financial firms which would supplement the current caps on the market share of their deposits.

I think the Administration is headed in the right direction with these two proposals. Now, I know the timing of them and how they have been proposed at a critical time when we have been deeply engaged on this Committee on proposing ideas to reform the financial services sector has raised the eyebrows and other considerations by people. But I think we need to get past that, if we can, and think about the merits of these ideas and how they would work if they could, in fact, be put in place. So I would welcome the conversation we are going to have today and the remainder of this week on these issues.

These proposals deserve our serious consideration, and so today we will have from the Chairman and the Deputy Secretary of the Treasury, Neal Wolin, and on Thursday we will hold another hearing with business and academic experts.

These proposals were born out of a fear that a failure to act would leave us vulnerable to another crisis and a frustration at the refusal of financial firms to rein in some of these more reckless behaviors. I share that fear, and I share that frustration as well. And I strongly oppose those who would argue that the boldness of these proposals is out of scale with the need for reform. We need to take action, and we must consider scaling back the scope of activities banks may engage in while they are using deposits.

And so today I look forward to hearing how these proposals may be most effectively applied to protect consumers and our economy and also, as a devil's advocate, why these ideas may not work and what risks they may pose if adopted.

Some have objected to the Volcker rule on the grounds that it might not have prevented the crisis or that these particular limits are unwise. I think those objections are worth discussing, and I am interested in giving our witnesses and our colleagues here a chance to raise these items and a chance to have the kind of vibrant, robust debate and discussion about them. But we must take steps, I believe, to change the culture of risk taking in our financial sector, including the management and compensation incentives that drove so much of the bad decisionmaking.

I applaud the Administration's commitment to scaling back risky behavior on Wall Street, and I thank Chairman Volcker and Deputy Secretary Wolin for joining us today to share their thoughts and ideas on these proposals. And I look forward to working with them and, of course, my colleagues here on this Committee, Democrats and Republicans, as we have been working over these past many weeks and months, to fashion a reform package that would allow us to step forward on a bipartisan basis here, a consensus bill that we could bring to our other 87 colleagues in the Senate for their consideration and ultimately a conference with the other body and ultimately, of course, for the signature of the President of the United States.

We have a lot of work left to be done, so this debate is an important one, and we welcome you today to share your thoughts and ideas on these proposals.

Senator Shelby.

#### **STATEMENT OF SENATOR RICHARD C. SHELBY**

Senator SHELBY. Thank you, Mr. Chairman.

Chairman Volcker, welcome again to this hearing. I think one of my first few weeks on this Committee was you testifying when you were Chairman of the Federal Reserve. That was a few moons ago, as we both know, but we welcome you back.

The financial crisis has had a devastating effect on our economy. Millions of people have lost their jobs, trillions of dollars of household wealth have evaporated, and the American taxpayer is on the hook for nearly all of it. We cannot allow such a calamity to occur again.

For this reason, and others, I am willing to consider any proposal that will strengthen our regulatory framework and help our economy, including the President's latest recommendations. That is why I joined my Republican colleagues and asked for this hearing. Today, we hope we can gain a better understanding of the specific activities that would be banned under the President's proposal and the risks associated with those activities. We also need to understand clearly the costs and the benefits associated with the plan's proposed changes. Finally, we need to determine whether we should incorporate the President's latest ideas into the current regulatory reform debate or whether they can be considered at a later date.

I believe our main goal today in regulatory reform must be to eliminate taxpayer exposure to private risk while establishing the strongest, most competitive, and economically efficient regulatory structure possible. Achieving this goal will involve ending bailouts, addressing "too big to fail," reorganizing our financial regulators, strengthening consumer protection, and modernizing derivatives regulation, among others.

Putting this together in a legislative package is a very difficult task, yet as difficult as our task may be, I remain committed to considering any concept that may help us achieve our overarching goal.

With that said, however, I am quite disturbed by the manner in which the Administration has gone about introducing their latest proposals for consideration. We are more than a year into our de-

liberation on regulatory reform. The House already has completed action. Regrettably, the Administration waited until a little over a week ago to bring this very significant concept to the table. Seven months after the Administration first introduced broad recommendations that the President characterized as “sweeping reform not seen since the Great Depression,” this concept that we have before us today was air-dropped into the debate.

I applaud Chairman Dodd for giving us the opportunity to begin a thoughtful process regarding the President’s latest notions on regulatory reform. I hope, however, that this is not an indication that the Administration intends to substitute thoughtful analysis with whatever polls will on a given day. This is too important, it is too complex to be subject to the vagaries of political litmus testing. I know Chairman Volcker knows this, and I hope that he will continue to work with us.

Mr. Chairman, last fall you offered a regulatory reform discussion draft, and while I supported your policy aims, I questioned the means at that time. In response, you rightly slowed the process to consider more carefully how to accomplish our mutual objectives. I believe we have made tremendous progress in that regard. Whether we ultimately reach a consensus remains to be seen, but we are working at it. And as I have said many times, we must get it right, and this is a goal that I know we both share.

Thank you.

Chairman DODD. Thank you, Senator Shelby.

Do any other members want to be heard on this matter? I made that offer before.

Senator BUNNING. Can I put one in the record?

Chairman DODD. Any comments at all in the record, by the way, obviously we will include that. I presume members may have opening statements, and they will be included in the record.

Chairman DODD. Chairman Volcker, again, I think most people here know you, but just for the sake of the record here, Paul Volcker currently serves as Chair of the President’s Economic Recovery Advisory Board. He also heads up the Group of 30, which has been engaged internationally on financial regulations and last year released a very influential report, I might add, on financial reform. And prior to this time, as I think all on this Committee know and others working in the investment banking world, Chairman Volcker served as Chairman of the Federal Reserve from 1979 to 1987 under Presidents Carter and Reagan.

Neal Wolin serves as the Deputy Secretary of the Treasury, having been confirmed by the Senate in May of this past year. Prior to assuming this position, he served in the Administration as Deputy Assistant to the President and Deputy Counsel to the President for Economic Policy. Prior to that, Deputy Secretary Wolin was the chief operating officer of the Hartford Financial Services Group and also served in various positions with the Clinton administration.

Very impressive records, both of you. Chairman Volcker, again, welcome once again. You have been before this Committee on countless occasions over many years, over the past 30 years, and we welcome you here once again.

**STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, PRESIDENT'S  
ECONOMIC RECOVERY ADVISORY BOARD**

Mr. VOLCKER. Thank you very much, Mr. Chairman.

Chairman DODD. You have to turn that microphone on.

Mr. VOLCKER. A familiar location, but I forgot to push the button.

Let me say I do appreciate this unusual scheduling of the hearing. I did have a conflict this morning, coincidentally with the British Parliamentary Committee considering financial reform in Britain. So I am able to touch both sides of the Atlantic today with your rescheduling, and I appreciate that.

Let me say off the bat, making a very simple statement because I think there is some confusion. A lot of this issue we are talking about today revolves around proprietary trading, and some people say, well, is it a big risk or a small risk or whatever. It certainly is a risk. Everything the banks do is a risk. This is not a question in my mind of what is the greater risk. It is a question of what risks are going to be protected by the Federal Government through the safety net, through deposit insurance, through the Federal Reserve, and other arrangements. And my view is that commercial banks have an essential function in the economy, and that is why they are protected. But we do not have to protect more speculative activities that are not an inherent function of commercial banking, and we should not extend the safety net, extend taxpayer protection to proprietary activities. So that is a very short summary of at least one of the issues here.

As you know, the proposal that the President set out, if it was enacted, would restrict commercial banking organizations from certain proprietary and more speculative activities. But the first point I want to emphasize is that the proposed restrictions should be understood as part of the broader effort to deal with structural reform. It is particularly designed to help deal with the problem of too big to fail that Senator Shelby just emphasized—too big to fail and the related moral hazard that loom so large as an aftermath of the emergency rescues of financial institutions, bank and non-bank alike, in the midst of crises.

Now, attached to this statement is a short essay that appeared in the press on Sunday to try to point out that larger perspective, but the basic point is that there has been and remains a strong public interest in providing a safety net—in particular, deposit insurance and the provision of liquidity in emergencies—for commercial banks carrying out essential services. There is not, however, a similar rationale for public funds—taxpayer funds—protecting and supporting essentially proprietary and speculative activities. Hedge funds, private equity funds, and trading activities unrelated to customer needs, unrelated to continuing banking relationships should stand on their own, without the subsidies implied by public support for depository institutions.

Those quintessential capital market activities have become a part, a natural part of investment banks. And a number of the most prominent of those firms, each heavily engaged in trading and other proprietary activity, failed or were forced into publicly assisted mergers under the pressure of the crisis. It also became necessary to provide public support via the Federal Reserve, the Fed-

eral Deposit Insurance Corporation, or the Treasury to the largest remaining American investment banks, both of which assumed the cloak of a banking license to facilitate the assistance. The world's largest insurance company, caught up in a huge portfolio of credit default swaps quite apart from its basic business, was rescued only by the injection of many tens of billions of dollars of public loans and equity capital. Not so incidentally, the huge financial affiliate of one of our largest industrial companies was also extended the privilege of a banking license and granted large assistance contrary to longstanding public policy against combinations of banking and commerce.

Now, what we plainly need are the authority and methods to minimize the occurrence of those failures that threaten the basic fabric of financial markets. The first line of defense, along the lines of the Administration proposals and the provisions in the bill passed by the House last year, must be authority to regulate certain characteristics of systemically important non-bank financial institutions. The essential need is to guard against excessive leverage and to insist upon adequate capital and liquidity.

It is critically important that those institutions, its managers and its creditors, do not assume—do not assume—a public rescue will be forthcoming in time of pressure. To make that credible, there is a clear need for a new “resolution authority,” an approach recommended by the Administration last year and included in the House bill. The concept is widely supported internationally. The idea is that, with procedural safeguards, a designated agency be provided authority to intervene and take control of a major financial institution on the brink of failure. The mandate is to arrange an orderly liquidation or merger. In other words, euthanasia, not a rescue.

Apart from the very limited number of such “systemically significant” non-bank institutions, there are literally thousands of hedge funds, private equity funds, and other private financial institutions actively competing in the capital markets. They are typically financed with substantial equity provided by their partners or by other sophisticated investors. They are, and should be, free to trade, free to innovate, free to invest—and free to fail. Managements, stockholders, or partners would be at risk, able to profit handsomely or to fail entirely, as appropriate in a competitive free enterprise system.

Now I want to deal as specifically as I can with questions that have arisen about the President's recent proposal.

First, surely a strong international consensus on the proposed approach would be appropriate, particularly across those few nations hosting large multinational banks and active financial markets. That needed consensus remains to be tested. However, judging from what we know and read about the attitude of a number of responsible officials and commentators, I believe there are substantial grounds, very substantial grounds, to anticipate success as the approach is fully understood.

Second, the functional definition of hedge funds and private equity funds that commercial banks would be forbidden to own or sponsor is not difficult. As with any new regulatory approach, authority provided to the appropriate supervisory agency should be

carefully specified. It also needs to be broad enough to encompass efforts sure to come to circumvent the intent of the law. We do not need or want a new breed of bank-based funds that in all but name would function as hedge or equity funds.

Similarly, every banker I speak with knows very well what “proprietary trading” means and implies. My understanding is that only a handful of large commercial banks—maybe four or five in the United States and perhaps a couple of dozen worldwide—are now engaged in this activity in volume. In the past, they have sometimes explicitly labeled a trading affiliate or division as “proprietary,” with the connotation that the activity is, or should be, insulated from customer relations.

Most of those institutions and many others are engaged in meeting customer needs to buy or sell securities: stocks or bonds, derivatives, various commodities or other investments. Those activities may involve taking temporary positions. In the process, there will be temptations to speculate by aggressive, highly remunerated traders.

However, given strong legislative direction, bank supervisors should be able to appraise the nature of those trading activities and contain excesses. An analysis of volume relative to customer relationships and particularly of the relative volatility of gains and losses would itself go a long way toward informing such judgments. For instance, patterns of exceptionally large gains and losses over a period of time in the so-called trading book should raise an examiner’s eyebrows. Persisting over time, the result should be not just raised eyebrows but substantially raised capital requirements.

Third, I want to note the strong conflicts of interest inherent in the participation of commercial banking organizations in proprietary or private investment activity. That is especially evident for banks conducting substantial investment management activities, in which they are acting explicitly or implicitly in a fiduciary capacity. When the bank itself is a “customer”—that is, when it is trading for its own account—it will almost inevitably find itself, consciously or inadvertently, acting at cross purposes to the interests of an unrelated commercial customer of a bank. “Inside” hedge funds and equity funds with outside partners may generate generous fees for the bank without the test of market pricing, and those same “inside” funds may be favored over outside competition in placing funds for clients. More generally, proprietary trading activity should not be able to profit from knowledge of customer trades.

Now, I am not so naive as to think that all potential conflicts can or should be expunged from banking or other businesses. But neither am I so naive as to think that, even with the best efforts of boards and management, so-called Chinese walls can remain impermeable against the pressures to seek maximum profit and personal remuneration.

Now, in concluding, I have added a list of the wide range of potentially profitable activities that are within the province of commercial banks. Without reading that list, the point is there is plenty for banks to do beyond any concept of a narrow banking institution. It is quite a list, and I submit to you to provide the base for strong, competitive, and profitable commercial banking organiza-

tions able to stand on their own feet domestically and internationally, in fair times and foul.

What we can do and what we should do is to recognize curbing the proprietary interests of commercial banks is in the interest of fair and open competition as well as protecting the provision of essential financial services. Recurrent pressures, volatility, and uncertainties are inherent in our market-oriented, profit-seeking financial system. But by appropriately defining the business of commercial banks, and by providing for the complementary resolution authority to deal with an impending failure of large capital market institutions, we can go a long way toward promoting the combination of competition, innovation, and underlying stability that we seek.

Thank you.

Chairman DODD. Thank you very much, Mr. Chairman.  
Secretary Wolin.

**STATEMENT OF NEAL S. WOLIN, DEPUTY SECRETARY,  
DEPARTMENT OF THE TREASURY**

Mr. WOLIN. Chairman Dodd, Ranking Member Shelby, members of this Committee, thank you for the opportunity to testify before this Committee today about financial reform—and, in particular, about the Administration's recent proposals to prohibit certain risky financial activities at banking firms and to prevent excessive concentration in the financial sector.

The recent proposals complement the much broader set of reforms proposed by the Administration in June, passed by the House in December, and currently under active consideration by this Committee. We have worked closely with you and with your staffs over the past year, and we look forward to working with you to incorporate these additional proposals into comprehensive legislation.

The goals of financial reform are simple: to make the markets for consumers and investors fair and efficient; to lay the foundation for a safer, more stable financial system, less prone to panic and crisis; to safeguard American taxpayers from bearing risks that ought to be borne by shareholders and creditors; and to end, once and for all, the dangerous perception any financial institution is too big to fail.

From the start of the financial reform process, we have sought to constrain the growth of large complex financial firms, through tougher supervision, higher capital and liquidity requirements, the requirement that larger firms develop and maintain rapid resolution plans, and the financial recovery fee which the President proposed at the beginning of January.

In addition, both the Administration's proposal and the bill passed by the House would give regulators explicit authority to require banking firms to cease activities or divest businesses that might threaten the safety of the firm or the broader financial system. The two additional reforms proposed by the President a few weeks ago complement those reforms and go further. Rather than merely authorize regulators to take action, we propose to prohibit certain activities at banking firms: proprietary trading and the

ownership or sponsorship of hedge funds and private equity funds, as well as to place limits on the size of the largest firms.

Commercial banks enjoy a Federal Government safety net in the form of access to Federal deposit insurance, the Federal Reserve discount window, and Federal Reserve payment systems. These protections, in place for generations, are justified by the critical role that the banking system plays in serving the credit, payment, and investment needs of consumers and businesses.

To prevent the expansion of that safety net and to protect taxpayers from the risk of loss, commercial banking firms have long been subject to statutory activity restrictions. Our scope proposals represent a natural evolution in this framework.

The activities targeted by our proposal tend to be volatile and high risk. The conduct of such activities also makes it more difficult for the market, investors, and regulators to understand risks in major financial firms and for their managers to mitigate such risks. Exposing the taxpayer to potential risks from these activities is ill-advised.

In addition, proprietary trading, by definition, is not done for the benefit of customers or clients. Rather, it is conducted solely for the benefit of the bank itself.

Accordingly, we have concluded that proprietary trading and the ownership or sponsorship of hedge funds and private equity funds should be separated from the business of banking and from the safety net that benefits the business of banking.

This proposal forces firms to choose between owning an insured depository institution and engaging in proprietary trading, hedge fund, or private equity activities. But—and this is very important to emphasize—it does not allow any major firm to escape strict Government oversight. Under our regulatory reform proposals, all major financial firms, whether or not they own a depository institution, must be subject to robust consolidated supervision and regulation—including strong capital and liquidity requirements—by a fully accountable and fully empowered Federal regulator.

The second of the President's recent proposals is to place a cap on the relative size of the largest financial firms.

Since 1994, the United States has had a 10-percent concentration limit on bank deposits. This deposit cap has helped constrain the concentration of the U.S. banking sector, and it has served the country well. But its narrow focus on deposit liabilities has limited its usefulness.

With the increasing reliance on non-bank financial intermediaries and non-deposit funding sources, it is important to supplement the deposit cap with a broader restriction.

Before closing, I would like to emphasize the importance of putting these new proposals in the broader context of financial reform. The proposals I have outlined do not represent an "alternative" approach to reform. Rather, they complement the set of comprehensive reforms put forward by the Administration last summer.

Added to the core elements of effective financial reform previously proposed, the activity restrictions and concentration cap that are the focus of today's hearing will play an important role in making the system safer and more stable. But like each of the

other core elements of financial reform, the scale and scope proposals are not designed to stand alone.

We look forward to working with you to bring comprehensive financial reform across the finish line. Thank you, Mr. Chairman and Senator Shelby.

Chairman DODD. Thank you very much, Mr. Secretary.

We have a good participation here by members, so I will ask the Clerk to—why don't you put up 7 minutes on the clock for each of us, and again, I won't rigidly hold anyone to that, but sort of keep in mind that timeframe. We will ask both of our witnesses, if you can, to try and not filibuster. Although it is a habit here, we are not going to allow it with our witnesses, not too often, anyway. So if you will, try and keep your answers brief.

Let me just say at the outset, again, I think the proposal you are making makes sense to me. But the question is, that we have as a Committee in the coming days, is crafting a bill. Any good idea, including this one, can have unintended consequences. What are the effects of this? How does it work? How do you put it into place? So I want to emphasize for my line of questioning, anyway, that while I am supportive of this idea, I want to raise some questions about the practicalities of how this would function and work, and so I begin with that in mine.

Let me begin, if I can, because observers and others, and I am sure we will hear on Thursday some of these issues, not to mention today, as well, maybe from the members here themselves, have raised questions about how this prohibition on proprietary trading should be interpreted. How should Congress, for instance, set the boundaries of proprietary trading? Presumably, a separate trading in the design to produce trading profits would be prohibited. That is the presumption. But can we clearly separate bank hedging behavior, which I presume is something we would insist upon, from profit-making trades? How do you separate those activities? Would regulators have a difficult time enforcing this prohibition when you have that dual conflict, it seems to me, occurring?

Why don't you begin. I don't care, either one of you can begin. Paul, if you want to start that.

Mr. VOLCKER. Well, I addressed that question to some extent in my testimony, Mr. Chairman. It does put a burden, I think, inevitably, on the supervisor and the legislative intent ought to be very clear. Essentially, trading for one's own account unrelated to customer trading would be prohibited. Trading incidental to a customer relationship would be permitted.

Now, how do you make that distinction? I think you can do it clearly over a period of time with sufficient accuracy to make the policy appropriate. One thing, as you said, you just look at sheer volume compared to the volume of customer business. You look at the pattern of gains and losses, which have a strong suggestion of proprietary trading, because if you are just quickly accommodating a customer, there are not likely to be big gains or losses.

You don't have to have a cliff prohibition. It is clear that you want prohibition of purely proprietary trading, but if the other volume gets big enough to raise suspicion, you have the tool of capital requirements, which I think should be available and is available to the supervisor to suggest in a particular circumstance there ought

to be a very heavy capital charge for this activity, and that would automatically limit it.

Chairman DODD. Secretary Wolin?

Mr. WOLIN. Thank you, Chairman Dodd. I agree with Chairman Volcker. I think that there are important questions here, obviously. I think we would basically want to embed in statute the basic principle that if it is not customer-related, that it is proscribed, but that if it is related to customer activity and hedging customer activity or making markets with respect to customer services, that that is on the other side of the line—

Chairman DODD. But how does hedging—if you are hedging at a bank, isn't that to the advantage of the customer of the bank, as well, so that the bank doesn't end up in financial trouble?

Mr. WOLIN. That is right, and Mr. Chairman, I think to the extent that they are doing proper hedging activity—and right now, regulators and accountants and so forth look at hedging activity and make judgments about whether it is true hedging activity or not all the time—I think that a big burden is to be placed on regulators in implementing the basic principle that I have just articulated and that Chairman Volcker has articulated, and I think they do this in a range of ways, including with respect to hedging currently and whether it is legitimate hedging activity or whether it is something else, with the basic principle again being whether it is customer-related or whether it is for the firm's own balance sheet.

Chairman DODD. But you acknowledge this is an area where it poses some challenges for the regulator?

Mr. VOLCKER. Well, it is an area you have got to work on and establish policies and procedures. I point out that accountants already face this problem in developing accounting standards as to which transactions of a bank are hedging and which are not hedging in accounting reporting.

Take the case of AIG. They were heavily into credit default swaps. A credit default swap is presumably a hedging instrument. But I don't think anybody would look at what AIG was doing and say, oh, this is a hedging operation. It is not a trading operation. It was obviously a trading operation. It had nothing to do with protecting AIG. In fact, it was ruining AIG, it wasn't protecting it. And they were engaging in credit default swaps with people who were perhaps speculating on the other side.

Chairman DODD. I thought one of the problems there was they didn't hedge enough.

[Laughter.]

Mr. VOLCKER. They didn't hedge.

Chairman DODD. They didn't do what bookies do. They didn't lay off their bets.

Mr. VOLCKER. That is quite right.

Chairman DODD. Let me ask you this, because your testimony on page three, Chairman Volcker, because this is an important point, I think, and you make it in your statement, you say—and I am talking to your first point here on page three. You say, first, surely a strong international consensus on the proposed approach would be appropriate, particularly across those few nations hosting large multinational banks, and you pointed out there may be 12 or so

around the world that would fall into this category, and active financial markets. Further down, and I will just read the last clause, "I believe there are substantial grounds to anticipate success as the approach is fully understood."

Again, being the devil's advocate, to some extent, because obviously the question is raised here, for us to impose this kind of a rule and not to have a complementary set of rules adopted internationally makes this basically unworkable, to a large extent.

Now, to what extent—I agree with you. I would like to see the international community adopt what we would adopt here. But you have got a heightened degree of anticipation of this occurring, maybe more so than we could anticipate. Do we make ourselves vulnerable by insisting upon a certain standard here that we have to hope the international community might adopt, and if they don't, then we have left our institutions exposed to a vulnerability?

Mr. VOLCKER. Well, I don't think it is impossible for us to do it alone if we had to. That is obviously not the desired outcome. But I wouldn't want to make the challenge too rigid. The really important other financial center, of course, is London, and if we can have some agreement, basically, a basic outline with the British, you have gone a long ways. Now, the Governor of the Bank of England has already called for an almost identical approach. The opposition party, at least, in the U.K. has indicated strong approach for development along this line. I cannot speak for—

Chairman DODD. They are not in government yet. The opposition party—

Mr. VOLCKER. No, I understand. I understand. But the parliamentary committee which has people that are in office will issue a report. The government will decide, not that parliamentary committee, but we will be interested—

Chairman DODD. How did that committee go? Were these issues raised—

Mr. VOLCKER. Pardon me?

Chairman DODD. You just said you had a hearing this morning with the parliamentary committee.

Mr. VOLCKER. Right.

Chairman DODD. Was this issue raised, and what was the response?

Mr. VOLCKER. Yes, the issue was definitely raised.

Chairman DODD. And what happened? What was the reaction to it?

Mr. VOLCKER. Well, I told them—they pressed us to how wide this international comity ought to be and we discussed it was particularly important between the British and the United States. You may have noticed that President Sarkozy made some welcoming comment—

Chairman DODD. Yes, I saw those.

Mr. VOLCKER.—about President Obama's initiative. The Finance Minister of France did, as well. So there is some quarreling among the banks, there is no doubt about it, relatively few banks. But I think the prospects for achieving what I think and many other people think is a very sensible approach is good.

Chairman DODD. Neal, do you want to comment on this?

Mr. VOLCKER. Yes, Mr. Chairman. I would just add, the proposals that the President put forward a week or two ago with respect to scale and scope, I think are consistent with the principles that have been articulated by the G-20 leaders in London last year, again in Pittsburgh. A lot of the implementation work in that process is being carried out by the Financial Stability Board, and last week, the Chairman of that Board, Mr. Draghi, put out a statement consistent, I think, with some of the statements that Chairman Volcker was talking about, welcoming these proposals as a constructive part of this whole dialog with respect to financial reform.

So I think we are moving forward in terms of creating agreement amongst the G-20. Obviously, we will need to keep at it. But I think there is reason to believe that this is consistent with a lot of the discussion that is happening in those fora.

Chairman DODD. Well, let me just say, and I will conclude on this and turn to Senator Shelby, I think it is also important in the United States to lead. We are the leading country in financial services, and I think if we don't act, then we leave ourselves—others are not apt to follow. So while I raise these questions about cooperation, I think this is an important moment for the United States to demonstrate that it gets this and understands what needs to be done, and that by doing this or setting something like this in place, I think you raise significantly the possibility others will follow. If we don't act, I think you can almost make a similar prediction—

Mr. VOLCKER. That is very important.

Chairman DODD.—see that, as well.

Senator Shelby?

Senator SHELBY. Thank you, Mr. Chairman.

Chairman Volcker, commercial banks did engage in activities considered to be investment banking prior to the repeal, including some proprietary trading. But there does not seem to be evidence that I have seen that proprietary trading created the losses that resulted in the rate need and race for bailouts. Some argue it is questionable how curtailment of proprietary trading will protect the financial system from future instabilities, what we are going after.

In addition, there are notable examples of failed institutions, such as Bear Stearns, Lehman Brothers, among others, that were at the root of the recent crisis but did not engage in commercial banking and were more dangerous by being interconnected than by being large. And while AIG did have a small thrift—it was a very small thrift—the systemic threat from AIG did not emerge from that thrift.

Would you just share with us what you believe are the top three institutions that were engaged in proprietary trading and discuss what it was about these institutions that contributed to the financial crisis that we are confronting now?

Mr. VOLCKER. Well, in following the development of the financial crisis, which was the mother of all financial crises, it was quite clear, particularly in the American perspective, that the financial crisis, the panic, the defaults, were proceeding through proprietary trading-oriented institutions, beginning with Bear Stearns and losses in hedge funds, and they were a trading institution. Lehman

was very much a trading institution, Merrill Lynch, so forth. Some of them got saved by——

Senator SHELBY. But none of these firms were banks, commercial banks, at that time, were they not?

Mr. VOLCKER. Well, the commercial banks got in trouble, too, but——

Senator SHELBY. I know that, but these firms you just listed——

Mr. VOLCKER. These firms I just listed——

Senator SHELBY. Yes, sir.

Mr. VOLCKER.—were not commercial banks until they were given a commercial—a bank holding company in the midst of crisis.

Senator SHELBY. Right. Yes.

Mr. VOLCKER. That is right. Now, all I am saying is that was a demonstration that proprietary trading can be risky. Now, how can we bring that to heel, so to speak, and what this program suggests is two things. They will have the oversight body, we call it the oversight body, who can intervene with any capital market institution that is both large or very interconnected and presenting a risk to the whole system and limit the leverage, which had not been limited prior to the crisis. And the capital and liquidity had not been overseen. They ran free.

And very important, we want to set up a system, and this is the whole philosophy, that those institutions will not again be rescued.

Senator SHELBY. That is right.

Mr. VOLCKER. If they get in trouble, they are going to fail, and that will make their own financing more difficult, or less easy, and presumably in itself tend to contain their leverage. So between the oversight and their natural self-protective instincts, hopefully, knowing that they are not going to be saved, we reduce the chance of crisis.

Senator SHELBY. Dr. Volcker, one of the President's recent proposals is a limit on consolidation in the financial sector. In particular, the President proposal would, to quote from a White House press release, quote,

place limits on the excessive growth of the market share of liabilities at the largest financial firms to supplement existing caps on the market share of deposits.

Along those lines, I have three questions. First, could you elaborate on what constitutes excessive growth and on what particular liabilities restrictions will be imposed there? In other words, what would excessive growth be? This is important.

Mr. VOLCKER. Well, I think the only answer I can give there is like pornography. You know when you see it.

[Laughter.]

Senator SHELBY. You need to see it.

Mr. VOLCKER. I think Deputy Secretary——

Mr. VOLCKER. You might see it, but would the regulators see it?

[Laughter.]

Mr. VOLCKER. Well, the regulators won't see it unless you give them some instruction.

Senator SHELBY. Yes.

Mr. VOLCKER. Let me give you a little bit of history on this point. I haven't been engaged in these discussions——

Senator SHELBY. Yes, sir.

Mr. VOLCKER.—and Neal ought to say something to the point, but I have been around for a while and I proposed to this Committee at one point, and maybe it was the House committee, in the 1980s, when there wasn't any interstate banking, that we should have nationwide banking, but we didn't want it dominated by just a few institutions, and we modestly suggested perhaps a 5-percent limit ought to be appropriate for any one bank in terms of deposits. Well, when the Congress finally got around to acting, they made the limit 10 percent.

Now, I don't know exactly what limit they are going to talk about now, but I am sure it is more than 10 percent in assets relative to the country. So let me say, it is a matter of judgment, but if you are talking 15 percent, I would say that is a pretty big institution in the United States.

Senator SHELBY. That is a huge institution.

Mr. VOLCKER. A huge institution.

Senator SHELBY. Dr. Volcker, my second question along those lines would be, could you tell me, or tell the Committee, actually, what limits will be on a firm's share of similar liabilities in the U.S. banking system in the global market or in a market in each country in which a U.S. firm operates? Or, let us say it is a foreign firm operates in this country. We have a lot of banks domiciled overseas that operate here.

Mr. VOLCKER. That is correct.

Senator SHELBY. How would that work? How—

Mr. VOLCKER. Well, I would hope that those banks that are really major, domiciled overseas but operating here—

Senator SHELBY. Yes.

Mr. VOLCKER.—or owned overseas, would be in countries that adopt a similar approach. The big banks are in the U.K., they are in Paris. There is one in Germany. There are some in Japan, but the Japanese banks don't do this sort of thing anyway, so they are no question. The Chinese banks suddenly aren't going to become big proprietary traders in our market, I don't think.

When you take care of Europe and the U.K., there may be a dozen banks there, maybe 20 if you mix in Canadian banks, and they provide competition here, which I think is good, but the competition ideally ought to be on similar grounds and they follow the same general proscriptions.

Senator SHELBY. Dr. Volcker, it is my understanding from counsel that under existing laws and regulatory authorities—existing laws—banks and holding companies can be limited with respect to trading activities, including proprietary trading, under the safety and soundness considerations. Could you explain why you believe current authority is not adequate, if you do, and why you believe regulator discretion should be eliminated by statutory prescription?

Mr. VOLCKER. Well, this is another area that I have—

Senator SHELBY. Do you have the concerns we do with a lot of the regulations—

Mr. VOLCKER. Pardon me?

Senator SHELBY.—the regulators?

Mr. VOLCKER. I have been around a little while—

Senator SHELBY. I know.

Mr. VOLCKER.—partly as a regulator, sometimes contesting with the regulators, and I will tell you, if you just have a general permission for a regulator to put on adequate controls, the regulator ends up in an impossible position during fair weather, because all the banks will say, what are you talking about? Nothing has happened. My trading is perfect. We haven't had any big losses. You can't restrict us. I am going to go down to the Banking Committee and tell them you are going to be unfair and unreasonable, and that tends to be a bit persuasive of the regulators.

I think you need a hard legislative proscription rather than a kind of loose—the House bill has a voluntary kind of provision, and if you just take away the word “voluntary” in the House bill, I think you have got a better bill—

Senator SHELBY. Yes, sir.

Mr. VOLCKER. and say it is prohibited, not voluntarily permitted.

Senator SHELBY. Secretary Wolin, do you want—

Mr. WOLIN. Senator, I just wonder whether I could add something on the questions that you raised with respect to the size constraints.

Senator SHELBY. Yes, sir.

Mr. WOLIN. We believe that an important piece of trying to put an end to too big to fail is to constrain the size of financial institutions. That is something, as I suggested earlier, that is already well embedded in law. The problem with the deposit cap, which, of course, is such a device, is that it only applies in the sense to the safest kinds of liabilities a financial firm can have, and, at least implicitly, causes firms that want to grow beyond the funding or liability base that deposits represent into other sorts of funding which are riskier, still.

And so we believe that in order to update, in effect, and make useful in a world in which deposits are no longer really the only or even the core source of funding for these biggest firms, that you need to have a definition of size that is more broadly gauged.

Senator SHELBY. Quickly, Mr. Chairman, consensus on these proposals—Mr. Wolin, part of the uncertainty created by recent proposals from the Administration regarding banks stems from uncertainty about cohesion among members of the Administration and among regulators. Following the announcement of the Volcker Rule and size limits, for example, Reuters reported that Treasury Secretary Geithner may have expressed doubts about the utility of size limits. Reports from July of last year identified possible disagreement between FDIC Chairman Sheila Bair and Secretary Geithner concerning bans on proprietary trading by banks.

According to Chairman Bernanke of the Federal Reserve, bans on proprietary trading for commercial banks may not be constructive. Dr. Summers, Chief Economic Advisor in the current Administration, in the past has been a vocal proponent of removing Glass-Steagall restrictions on banks.

My question is this. Is there a consensus within the Obama administration and among the regulators concerning the Volcker Rule and restrictions on size? And if so, what process—what was expressed there?

Mr. WOLIN. Thank you, Senator Shelby. I think that is obviously a very important question. The proposals that the President articu-

lated with respect to size and scope 2 weeks ago were ones that were based on a consensus recommendation of all his economic team. And I think you have heard Secretary Geithner and you see Director Summers now speak to that quite directly.

I think, with respect to the regulators, they are, of course, independent, so I think I feel slightly less comfortable expressing their views. But I do think that in the main, they are also supportive of this and we will work together with them and obviously with this Committee to try to move these ideas forward as an important part, we think, of making sure that firms are not overly risky and that the system itself is not overly risky.

Senator SHELBY. Mr. Chairman, you are being generous. I just want to make one statement, quickly. I don't believe myself that being big is necessarily bad. But I do believe that being big and thinking the government is going to bail you out is bad. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Merkley?

Senator MERKLEY. Thank you very much, Mr. Chair, and thanks to both of you for your testimony.

I wanted to start by going to this distinction between trading in a fashion that is related to your customers and trading on your own account. One person summarized this by saying, it is like a grocery store that puts peanut butter on its shelf for its customers versus buying a whole warehouse of customer because it wants to speculate on how much peanut butter will be worth next week.

I think that in your testimony, Mr. Volcker, you referred to a volume rule, and I believe that goes to the heart of how you distinction between peanut butter on the shelf to service customers and a warehouse to speculate on the price. Could you give us any more details on how that might work, and how much needs to be done by this body and how much needs to be, if you will, delegated so the fine print can be worked out by experts in the field?

Mr. VOLCKER. Well, I think the answer to your question, it is going to have to be worked out by the regulators and supervisors. But I think what is important is you give them very firm directions as to what the object is, that proprietary trading is out. Trading incidental to a customer relationship is OK. You be careful about how you define that, but you are going to have to delegate it.

Senator MERKLEY. Mr. Wolin, do you wish to add anything to that?

Mr. WOLIN. No. I think that is our view.

Senator MERKLEY. OK. In addition to such trading on your own account creating risk, there is also the reference to it creating a conflict of interest when you are also managing funds, asset management and so forth. Do we have examples of—is that a theoretical problem—

Mr. VOLCKER. No, I don't think it—

Senator MERKLEY.—or have we seen real evidence of that in the field?

Mr. VOLCKER. I don't think it is at all theoretical, and I don't know what else I can say. It is very real. There has been quite a lot of discussion in the press and elsewhere, in particular institutions or particular agencies. It is bound to be real, because you are

bound to run into a conflict between dealing for your own account and a customer who may—in your dealing for your own account, you may go directly contrary to one of your customers' interests. It is inevitable.

It is inevitable, maybe not quite so inevitable, but it is very real that if you are doing a big customer business, that may help you kind of have a feeling about which direction the market is going in and might help your proprietary trading. It is just human nature, I must say, when you put these things together.

Senator MERKLEY. And so when firms respond by saying, and I think you referred to it in your testimony, they can create a Chinese wall within the firm, which I assume means the Great Wall of China, broad, large distinction, separation, your belief is we can't create—it is impossible due to human nature to create such a wall that would be effective.

Mr. VOLCKER. Well, I will tell you, I hate to tell you this story, but when I was a young officer of a bank and there was considerable controversy in the Congress about whether banks should be in the trust business and whether there were a lot of conflicts of interest, and I was asked in this bank to go examine this situation so that they could report to the Congress. I was just a young fellow and they said, look at the Chinese Wall. I thought they said Chinese Wall because they thought it was so permeable. I thought the Chinese Wall hadn't kept out the Huns. But that was not the meaning they meant to convey. But that initial impression of mine has never left me as I examined the Chinese Wall in that particular institution.

Senator MERKLEY. Thank you. I want to turn then to another piece of this, which is depository institutions have access to low-cost credit through the Fed, and one of my concerns is that our banks, our commercial banks do an effective job in fueling businesses in our economy, getting loans out the door. Is it a significant concern? Is it a legitimate concern that if you have proprietary trading, trading on your own account, that funds that might otherwise have gone out in the form of loans to fuel our economy might end up buying the inventory, if you will, the financial inventory?

Mr. VOLCKER. Well, I don't know if that is a big problem. Neal may want to speak to it. I don't believe the other is—sometimes you will the argument that they have to do proprietary trading to make a lot of money to support the lending business. I mean, I don't believe the banks think that, oh, I will make a lot of money in proprietary trading so I will go out and make more loans than I would otherwise make. They will make the loans if they think the loans are profitable, quite regardless of whether they are making or losing money in the proprietary trading, in my view.

Senator MERKLEY. Mr. Wolin?

Mr. WOLIN. Senator Merkley, I think it is an incredibly important question. You know, to the extent that firms are tying up capital through proprietary trading or in hedge fund businesses and so forth, the kinds of things that we have said we think should not be allowable by banking firms, they do not have that capital to be used for things like commercial lending activity and so forth. And so we think that, among other things, is a reason why this is a good set of proposals.

Senator MERKLEY. Could I ask you, Mr. Volcker, to expand a little bit on what the—or Mr. Wolin—on what the actual proposal would be for the 10 percent limit on other liabilities? What other liabilities might be included in that analysis?

Mr. WOLIN. So the answer, Senator, is we do not have the details of that fully nailed down. We want to make sure that we get it right. We want to work with the regulators, with this Committee in coming forward with a proposal. We don't think that it ought to be a limit that is currently binding. We have said that. But with respect to what exactly is the percentage and what is the, if you will, the denominator of this fraction, we have not yet landed. We are still working on that and would want to work with this Committee on that.

Senator MERKLEY. OK. Finally, in 30 seconds, the Basel II approach of internal risk limits that allows somewhat unlimited leverage in investment banks, do we need to rethink that and have more of a concrete leverage limit?

Mr. VOLCKER. If you want my response, I haven't been involved in those very complex discussions, but I think you do need to do some rethinking of Basel II with some more explicit overall leverage limit, I think is a good thing. But a lot of the Basel II stuff has to be clarified and made, I believe, more binding. It rested very heavily on banks' internal risk management procedures and on credit rating agencies. Both of those have been somewhat discredited in the past couple of years, so a lot of rethinking is involved there.

And that is a place where you need, speaking of common international per capita requirements, I think you do need a common standard. And getting agreement among a lot of—this is now a lot of countries. It is not just the United States and United Kingdom and Europe, it is Japan and China and emerging countries. And getting them all to agree is a challenge.

Mr. WOLIN. Senator, if I could just add, we do want to go forward with the implementation of Basel II. We have made that clear to our counterparts in Europe. But we also have said in the context of our White Paper and in the G-20 discussions that we think there ought to be leverage constraints, as well. And so we feel like there is an appropriate role for that in terms of, again, answering this basic question about core prudential standards and making sure that we deal with the too big to fail set of issues, at least in part, through other things, as well, but in part through tough standards on the front end.

Senator MERKLEY. Thank you both very much. Very helpful.

Senator JOHNSON. [Presiding.] Senator Corker?

Senator CORKER. Thank you, Mr. Chairman, and thank you both for being here.

Chairman Volcker, I thank you for the time in your office in New York and in here. There are very few people that could announce a policy, and we would have a hearing this quickly, and I think it shows a right respect we have for you as an inflation fighter.

Mr. VOLCKER. Thank you.

Senator CORKER. Secretary Wolin, thank you also for the many conversations.

Just to sort of put this in perspective, I know we have talked a lot about banks, but your proposal actually says that a financial holding company or bank holding company, a conglomerate that is a financial institution, that has a commercial bank as a component of it, could not engage in these activities that you have talked about.

Mr. VOLCKER. Yes. Let me be perfectly clear on that part. When I say bank, a bank as an organization, I mean all holding companies.

Senator CORKER. I know. I just say that for the listening audience. You are not just talking about the bank, but you are talking about the entire bank holding company, the affiliates that operate all around the world.

Mr. VOLCKER. Yes.

Senator CORKER. None of those could be involved in this.

And I just want to point out that while Senator Shelby did a great job of this line in questioning, I know this last crisis is causing us to focus on reform, and certainly we do not want to focus on the past always, but it is true that not a single organization that was a bank holding company or a financial holding company that had a commercial bank had any material problems at all with proprietary trading. That is a fact. Unless you refute that, I assume that will stand.

Mr. VOLCKER. Now wait a minute. I do not know how far back in history you want to go.

Senator CORKER. I am talking about this last crisis.

Mr. VOLCKER. Pardon me?

Senator CORKER. The last crisis. I know we spoke—

Mr. VOLCKER. On the last crisis, not going really far back in history, I recall at the beginning of the crisis there was a very large lawsuit on a French bank from a single rogue trader. It was one trader that went out and cost them hundreds of millions of dollars.

Senator CORKER. In the United States of America, there has not been a single institution. I just want to point that out. We can move on, but it is a fact.

Mr. VOLCKER. A banking institution or a non-bank?

Senator CORKER. There is not a single bank holding company in this last crisis that had a commercial bank that had issues that were material to failure relating to proprietary trading, not one.

Mr. VOLCKER. Well, I would have to go look and look at the proprietary trading, but there were certainly American banks that took substantial losses in their trading book.

Senator CORKER. Well, maybe we can get back on that. So let me just go a step further. I am going to say that that is a fact unless somebody tells me different.

Mr. WOLIN. I think obviously the causes of distress in these very big firms are multi-factorial, but I think there were plenty of bank holding companies that suffered losses in hedge funds that they owned or sponsored, or in their proprietary trading activities, that were part of the capital—

Senator CORKER. I am talking about material.

Mr. WOLIN. For even material that caused, were part of why taxpayer money was committed, and so you know to pinpoint a single

reason why this or that firm, I would say this is clearly one of the reasons.

Senator CORKER. OK, let me move on. My point stands, and we can talk about that. I take your point.

Let me also make another point, that the capital of a bank, a commercial bank within a bank holding company or financial holding company, cannot leave and go to any other part of that affiliate without reducing the capital of that commercial bank, which reduces their ability to make loans and do that sort of thing. You all acknowledge that.

Mr. WOLIN. There are firewalls, Senator, absolutely, between the activities or the relationships between the banks.

Senator CORKER. I am talking about the bank's capital cannot leave the commercial bank and go to the other parts of the bank holding company without taking a reduction in capital at that commercial institution. That is a fact.

Mr. WOLIN. Right, but, Senator, of course, to the extent that capital is fungible in some sense and—

Senator CORKER. Twenty-three A and B limit that.

Mr. VOLCKER. Look, I do not understand that at all, Senator. I used to regulate bank holding companies. If you think they cannot find ways of moving capital from one part of the holding company to another over time—

Senator CORKER. No. I am talking about leaving the commercial banking operation. It cannot leave it without reducing the capital of that commercial bank.

Mr. VOLCKER. It may be that there is a restriction at a particular point in time from taking a lump of capital out of the bank into another part of the holding company. Over time, they will reallocate that capital the way they want to.

Senator CORKER. And they have to take a reduction in the bank's capital when they do that, the commercial bank's capital.

So let me just ask a couple questions. I am just making that point to say that there are firewalls that exist and that no bank holding company failed, that had a commercial bank, due to proprietary trading or hedge funds or any of the activity we are talking about, and this is just in recent times, in the United States.

So let me ask a question. For client good, could one of these institutions or their affiliates make a market for a client? I think the answer is yes. Is that under your proposal?

Mr. VOLCKER. They certainly deal in response to a client's need.

Senator CORKER. If they wanted to sponsor a hedge fund, so that a client would know that the Volcker bank was creating a hedge fund and was going to seed capital, could they do that just to know that the bank had an investment there and it was a good enough investment for their client to be involved in? Would that be illegal under this proposal?

Mr. VOLCKER. It would not be legal, if I understand the question, for the bank to sponsor a hedge fund.

Senator CORKER. Even if they were just putting seed capital in it to show good faith?

Mr. VOLCKER. Yes.

Senator CORKER. Could a community bank trade bonds or mortgage-backed securities within their portfolio to balance it out?

Mr. VOLCKER. Yes.

Senator CORKER. But that is proprietary trading, right?

Mr. VOLCKER. Well, you said, you put the important word there, to balance out. If they run into an occasion where they had too much of this and too little of that

Senator CORKER. So let me ask this question. If we have a bill that, as you used the word, ends a company, creates euthanasia, and I think we might end up having a bill like that. If we have a bill that stipulates capital requirements, that says that if you are going to be in these risky areas of activity, that higher capital is going to be required, and I have an idea that we might end up with a bill like that. Would a proposal like this, through that lens, if those two areas were dealt with, would a bill like this or this type of legislation even be necessary?

Mr. VOLCKER. Well, I think it would certainly be very useful, and that is what the Administration has proposed, as I understand the question. I would not think the Congress is going to specify precisely what the capital requirement is, but they are going to give the supervisor the authority, direction, that yes, they can change that capital requirement depending upon the—

Senator CORKER. The risk.

Mr. VOLCKER.—designation as the riskiness of the—

Senator CORKER. Sorry. But if you had a resolution mechanism that said that if an institution failed, there were not going to be bailouts. They were going to be resolved out of business. And if you had a piece of legislation that stipulated that if a bank holding company engaged in risky operations, capital had to be increased, would there be a need for an arbitrary restriction of the type that has been laid out?

Mr. VOLCKER. Well, I think so for the reason that I suggested earlier, that without the Congress being very clear in law as to what kind of activity is restricted or eliminated, or not, over time in fair weather the restrictions will erode away because it is very hard to maintain very tough restrictions when nothing is happening.

And I think you need a clear legislative direction beyond a general statement that you were able to change. Supervisors can already change the capital requirement. They do not need legislation to do that. What they need is a clear legislative intent as to the acceptability of proprietary activities, in my view.

Senator CORKER. Mr. Chairman, I know my time is up. First of all, again I want to thank both witnesses for being here.

I think there has been a misnomer put upon the American people by many commentators who talk about the fact that we give money to these banks, and they use them in casino operations, when in essence there already are firewalls that exist. Capital cannot leave a commercial bank to other parts without a charge against capital, reducing the capital. That is just a fact.

And the fact is that foreign affiliates, I assume, would just be having these operations taking place in Dubai and other places.

It just seems to me that I appreciate very much the policy being forth, but it seems to me that it is being put forth without taking into account some of the other things that may be a part of this legislative process which would render it unnecessary.

Chairman DODD. [Presiding.] Go ahead. Do you want to comment?

Mr. WOLIN. Yes, sir, I just wanted to. Although the firewalls are obviously important, insofar as these banking firms get a lower cost of capital, a lower cost of funding because of their access to the safety net, the entire bank holding company gets the benefit of some of that benefit, meaning capital is fungible, and their overall costs on a systemwide, consolidated basis is lower on account of it. So what we are saying is that that advantage should not be put toward these higher risks, more volatile kinds of activities.

We agree that a higher capital standard is very important. We agree that the resolution authority of which you speak, absolutely critically important. But we also think that in order to make sure that taxpayers are not exposed to extra risk in these banking firms, that these three kinds of activities which are uncustomer-related ought to be proscribed.

Chairman DODD. Thank you, Senator.

Before I turn to Senator Warner, one of the things I wanted to make a point very briefly on is clearly we are looking back, and I think it is appropriate—where are the gaps we need to fill in, so we do not have a repetition of the problems that brought us to this point in crisis.

But one of the things we have also talked about, at least I have over the last number of many months, is looking forward as well. Not only is it a question of trying to plug gaps but also what is the architecture we are creating for the 21st Century that allows this Country to lead in financial services worldwide and, second, protect against potential problems that can emerge.

I do not want just the argument of fixing a problem that created the issues we are grappling with today, but also what do we need to be thinking about as a Committee and as a Congress that goes forward.

Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. I thank you and Senator Shelby for having this hearing.

Echoing Senator Corker, I appreciate the chances I have had to visit with you, Mr. Volcker, on this issue. And I do think there are challenges around some of the definitions, but I want to come back to that in a moment.

If we go back to, I think, your accurate recitation of how we kind of got here and acknowledging, as some of my other colleagues have said, that most of the initial folks who got us into this downward spiral were not the commercial banks but were investment banks, and that in the throes of the crisis that the Fed and others decided to allow these investment banks to convert into bank holding company status.

If we were to adopt the Volcker rule, in effect the first action would be, of a Morgan and a Goldman, they would lose that bank holding company status? Would that not be the first action they would take?

Mr. VOLCKER. Well, it would be their choice.

Senator WARNER. Recognizing how much of their book is based on proprietary, hedge funds.

Mr. VOLCKER. If they were going to maintain—I think those two institutions are quite different. But if they wanted to maintain a heavy emphasis on proprietary trading, they would have to give up the banking license, yes. If they wanted to retain the banking license, they would have to live within the rules of a bank.

Senator WARNER. Again, the concept being that the ability to have that access to the lower capital with the Fed window, that was the tradeoff, correct?

Mr. VOLCKER. Right.

Senator WARNER. You talk about three different areas: proprietary trading, private equity and hedge funds. I mean I know you have talked a little bit about definition on the proprietary trading act.

I do wonder. I used to be in the private equity business. There are private equity, subordinated debt, different types of instruments that kind of fall along that continuum of what we now broadly define as private equity. Some of those traditionally had been kind of traditional banking functions.

Mr. VOLCKER. I mean I think that is true. I was concerned about the opposite side of that, the fact that you could not prohibit something called an equity fund, and a bank that developed something that looked very much like an equity fund, but they did not call it an equity fund. And the false—

Senator WARNER. The same may be said about hedge funds, right?

Mr. VOLCKER. Yes, the same thing you say about hedge funds which could become often a vehicle for just conducting proprietary trading operations. That is why the legislative language I think has to be pretty clear, to tell the supervisors that if somebody is getting around the obvious intent of the rule, the supervisor can do something about it.

Senator WARNER. Would you care, or Secretary Wolin, would you care to rank? The legislative process is always a little bit of give and take here.

Is the primary aim here we want to try to prohibit the proprietary trading activities, and proprietary trading activities being remarked or remasked as a hedge fund or a private equity investment?

Or would you say, no, we want to take—the first thing we want to get rid of is the private equity and then hedge funds and, last, proprietary trading? Is there a rank order of these three?

Mr. VOLCKER. Not to me because I think to some degree they are substitutable, as you were saying. Some banker pointed out to me the other day my language is too limited. I should say something about real estate funds, which are really important to some banks. I kind of think of that as part of a private equity fund, but you could explicitly say real estate funds.

But I think there is enough substitution. I do not see any reason to permit one and not permit the other.

Senator WARNER. Secretary Wolin, is that also—

Mr. WOLIN. It is. I think the core distinction, Senator Warner, was customer, non-customer. Obviously, there are, and the regulators will have to deal with some definitional issues as they implement the basic principle if it were to be lodged in statute.

What we said is there are a whole lot of activities that traditionally have been in sort of the investment banking sphere, with respect to underwriting and asset management and so forth, which are OK. But as respects the three things that we think are not customer-facing and fundamentally more risky, riskier, I think I would avoid the opportunity to link within those.

Senator WARNER. I would concur with Secretary Volcker, that having been pitched by some of those firms along my career, those Chinese walls disappear oftentimes when you are being pitched as a potential client, the value of being able to kind of commingle and cross-mingle these different functions.

One of the things about this, and I know everybody else has raised this as well, is I kind of struggle with this size cap approach. Clearly, the deposit cap approach, as you have seen, the ability to kind of lever up outside the depository institution, has not created the kind of diminution of accumulation of capital and system risk in a few top institutions. I know where you are heading, and I am saying I do not completely disagree with that, although again the challenge comes how do you write it out.

From both the standpoint of putting American firms at a competitive disadvantage, I think the Chairman has raised that. If we do this and the rest of the world does not follow suit, and even if we are able to get some of our European friends to go along, could you see a migration to chartering some of these institutions in a kind of one-off company, country, that could avoid then this kind of restrictions even say the industrial world puts in place? But then we create a next generation of Cayman Island-based funds or firms.

Then do we also have the problem that we do not want to give an undue competitive advantage, which they do have at this point in terms of cost of capital, to these large firms? But, at some point, do the best people leave these firms when they start bumping against this size cap?

Mr. WOLIN. Well, I would say, Senator, and I think those are all extremely important questions, I agree with Senator Shelby that size by itself is not the only thing. But we do believe that it is an important element of risk and that there is a meaningful correlation in general between size and risk, and it is part of what we are trying to constrain, not the only thing to be sure.

I think on competitiveness U.S. banks are already relatively smaller than an awful lot of financial institutions in Europe and elsewhere in the world, and I think they compete awfully well as it stands. So I do not think that is liable to be a competitive problem.

As I think Chairman Dodd said, at the end of the day, the most important thing for the competitiveness of our financial system is that it is safe and sound, and that people will see it as safe and sound. And that will, I think, be an awfully important thing going forward to make sure that we do maintain the strong competitive position of the U.S. financial services industry.

So I think those are all considerations that we have for those questions.

Senator WARNER. But I think capital requirements, leverage restrictions, convertible debt requirements, funeral plans may also be other tools we could use——

Mr. WOLIN. Absolutely.

Senator WARNER.—that would not go at this plain, straight-out size.

Mr. WOLIN. No question, there are other tools. We think they are important other tools, but we believe that in the same way that the deposit cap is an important tool, but an insufficient tool, that we ought to also pay attention at some level, not in a way that binds currently. Some we are not talking about dismantling these firms, but that at some level size really does become an important element of systemic risk, and to be defined obviously together with you all and with the regulators.

Senator WARNER. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator JOHANNIS.

Senator JOHANNIS. Thank you, Mr. Chairman.

There are many things, as I think about where we are headed with financial reform, that I think there is consensus on. I think resolution authority. Gosh, I think most of us are there, if not all of us. Systemic risk and how we approach that, there may be some difference of opinion about how we approach it, but again I think we are there.

This one, though, I must admit I have sat through this hearing, and I get more confused as you testify. You are not really clearing up for me what we are doing.

So let me just ask a pretty straightforward, maybe a bit of a basic question to start out with. Tell me the evil that you are trying to wrestle out of the system by this rule. If we were just to say great, we are with you, we pass it the way you want it passed, what evil disappears?

Mr. VOLCKER. Well, I don't know if you want call it evil. I feel that I have failed if you are more confused than you were before.

Senator JOHANNIS. That is all right.

Mr. VOLCKER. What I want to get out of the system is taxpayer support for speculative activity, and I want to look ahead. If you do not bar that, it is going to become bigger and bigger, and it becomes, adds to what is already a risky business. And I do not want my taxpayer money going to support somebody's proprietary trading. I will make it as simple as that.

Senator JOHANNIS. But here is the problem, Mr. Chairman, and here is where I am struggling to follow your logic, and let me just give you some concrete examples. AIG, how would this have prevented all the taxpayer money going to AIG? If this rule had been in place, what would have been different? Anything?

Mr. VOLCKER. Well, first of all, I think AIG is a big insurance company that should have been better supervised in the first place than it was. If it had an effective supervisor of AIG and it had not been an affiliate of, what, a small thrift?

Mr. WOLIN. Small thrift.

Mr. VOLCKER. Somehow it was a bank because it had a small thrift appendix. Somebody should have been there and saying,

what are you doing over there in London, with trillions of dollars of credit default swaps? You are jeopardizing your business.

Senator JOHANNNS. But, see, we can stipulate to that. I have said many times, I have never seen so many people paid so much money to do so many stupid things.

Mr. VOLCKER. Right. Well, we want to shut off one area of stupid things.

Senator JOHANNNS. Yes, but let's say the Volcker rule had been in effect, would that have stopped AIG from doing this?

Mr. VOLCKER. If it was in effect for insurance companies, it certainly would have stopped that.

Senator JOHANNNS. OK. So you are saying that if the Volcker rule had been in place, AIG would not have happened?

Mr. VOLCKER. Well, you are assuming that the Volcker rule is in effect with an insurance company, which is not immediately at issue here.

Senator JOHANNNS. Right.

Mr. VOLCKER. If it had been in effect on an insurance company—

Senator JOHANNNS. OK, so we can kind of set that one to the side, I think.

Mr. VOLCKER.—and you had a particularly effective capital requirement alongside the complementary approach, I believe that we would not have had a trouble with AIG.

Senator JOHANNNS. Well, see, I think you are losing me again.

Mr. VOLCKER. I mean I am puzzled why I am losing you.

Senator JOHANNNS. Here is why you are losing me. I do not think the Volcker rule would have stopped the behavior of AIG.

Mr. VOLCKER. Why not?

Senator JOHANNNS. Because we are talking about banking institutions. They did not take deposits, right?

Mr. VOLCKER. Yes, yes, the fact that an insurance company was not covered is a different problem.

I think insurance companies. If you have the time, I would suggest that you enact a Federal supervisory agency for insurance companies too, but that is not right on the docket.

Senator JOHANNNS. Yes, but that is not what we are doing here today, and I am trying to figure out how—

Chairman DODD. Not only today, what about a limit? Thanks, Chairman Volcker, for another issue for me to grapple with.

[Laughter.]

Senator JOHANNNS. What I am trying to figure out, Mr. Chairman, is this, how we are going to even deal with preventing what happened by doing what you are asking us to do, and I do not see how we are getting there.

So AIG, I think your answer is saying we would even have to go further than what you are asking.

Now let me go to Lehman. Would we have solved the problems with Lehman, had the Volcker rule been in place? Are they not yet another institution that was not taking deposits but were doing some—

Mr. VOLCKER. The Volcker rule, much as I would like to say it solved all problems, does not solve all problems. It is part of a, I think, coherent reform of the financial system.

Lehman, under not just this issue, they are not a bank. So the rule would not have applied.

But under the general regulatory approach that has been proposed by the Administration, you would have had presumably a leverage restriction, a capital restriction on Lehman, and you would have had the resolution authority that you favor. I hope and believe that combination would have reduced a very good chance that Lehman would not have failed.

Senator JOHANNNS. Here is where I think we are getting to, though, based upon what you are saying to me, and I think it is now clear. You are saying I think, Mr. Chairman, that this is a great opportunity since we are doing financial reform anyway to put this rule in place. But it really would not have solved the problem with AIG. It really would not have solved the problem with Lehman.

Mr. VOLCKER. It certainly would not have solved the problem at AIG or solved the problem with Lehman, alone. It was not designed to solve those particular problems.

Senator JOHANNNS. Exactly. That is the point. You know. This kind of reminds me of what the Chief of Staff said, never let a good crisis go to waste.

What we are doing here is we are taking this financial reform, and we are expanding it beyond where we should be. And I just question the wisdom of that, unless somebody can make the case to me that had this been in place the world would have been differently.

Mr. Secretary—

Mr. VOLCKER. The Chairman made the point that I would emphasize, that the problem today is look ahead and try to anticipate the problems that may arise, that will give rise to the next crisis. And I tell you, sure as I am sitting here, that if banking institutions are protected by the taxpayer and they are given free rein to speculate, I may not live long enough to see the crisis, but my soul is going to come back and haunt you.

Senator JOHANNNS. That may be. There will be a lot of people. You would have to stand in line maybe.

[Laughter.]

Mr. WOLIN. Senator, if I could just add, I think your question is obviously a critically important one. The Volcker rule, were it to have been in place, I think would not have solved all the problems and nor is it the only piece of what we think is a comprehensive package of proposals. But there were plenty of bank holding companies that did suffer losses in their hedge funds and in their proprietary trading activity, that had capital holes that were in part therefore filled by taxpayer funds.

We think as we go forward the real goal here, at the end of the day, is to create a financial regulatory system in which firms do not pose undue risk and where the whole system in its entirety is well protected. Our view is that having banking firms that fundamentally subsidize their riskier activities in these areas because they have access to the safety net is something we can and should avoid as we construct a framework going forward.

Senator JOHANNNS. But here is the challenge that you have here today, I think, in trying to move this Committee in this direction.

The challenge is this: When you say, well, I can find some places where they lost money, my response to you on that is and you know what, I can find some places where they lost money on mortgages, on commercial real estate, on residential real estate.

So what are we getting to here?

Mr. VOLCKER. Let me try that one. Commercial banking, as I said, is a risky business. Now the question is whether you want to, in effect, provide a subsidy or provide protection when they are lending to small business, when they are lending to medium-size business, when they are lending to homeowners, when they are transferring money around the Country. Those are important continuing functions of a commercial bank, in my view, and I do think it is deserving of some public support.

I do not think speculative activity falls in that range. They are not lending to your constituents. They are out making money for themselves and making money with big bonuses. And why do we want to protect that activity?

I want to encourage them to go into commercial lending activity.

Senator JOHANNNS. But, see, you are assuming something about what I am doing. I do not like the bailouts. I voted against TARP, the second tranche of TARP. Quite honestly, I do not think we should put the taxpayer in that position.

But I also likewise think that if your goal is to try to wrestle risk out of the system, you get to a point where quite honestly you do not have a workable system anymore, and that is what worries me about where you are going here—is because you are using this opportunity to put into place something that has some pretty profound consequences, and I am not sure these circumstances justify that step. That is why I ask these questions.

Mr. VOLCKER. Well, that is a reasonable question. I am sorry I apparently cannot get through with the answer, but I do not want to restrict commercial banks from doing commercial banking, traditional business. I do not want to. I want to encourage their lending. I do not want to encourage their speculative activities.

Senator JOHANNNS. Let me just wrap up. I am out of time, and I thank the Chairman.

I really appreciate both of your being here. I really do. And we are wrestling with some very tough issues here, trying to figure them out, understand them, without damaging the economy.

Mr. VOLCKER. I understand.

Senator JOHANNNS. So it is critically important that we ask these tough questions.

Mr. VOLCKER. I am glad you asked them, because they have got to get answered.

Senator JOHANNNS. Thank you.

Chairman DODD. Thank you, Senator, very much.

Senator JOHNSON.

Senator JOHNSON. Thank you. Thank you, Chairman Volcker and Secretary Wolin.

Chairman Volcker, one of the actions taken by the Fed during the crisis was transforming large non-banks into bank holding companies with access to the Fed's discount window. What should be done with investment banks that became bank holding companies if the Volcker rule is adopted?

Mr. VOLCKER. Well, if the rule was adopted, they would not have been engaging, obviously, in some of these activities. But they could still get in trouble. Banks have had a history of centuries of getting in trouble. So that is one of the reasons we have a Federal Reserve. If they get in trouble and it seems to be a viable institution, a solvent institution, you have recourse to the Federal Reserve to handle even rather extreme liquidity needs, and I think that is totally appropriate. That is one form of Government support given to the banking system, and I do not see that changing. I think it is important to provide that backstop, and almost every country in the world provides that kind of backstop to its banking system. So that does not change.

Senator JOHNSON. Secretary Wolin, if the proposal includes a provision that gives banks the explicit choice to exit the bank holding company regime, do you have any concerns that this would create new regulatory gaps? Are there concerns that American companies would go abroad where there are not proprietary trading restrictions?

Mr. WOLIN. Senator Johnson, I do not think that we are likely to see regulatory gaps. Our proposal would say whether you choose to be a bank holding company or a financial company that can do these other activities, you would still be subject to the overall consolidated supervisory regime that has strong capital standards, leverage requirements, liquidity requirements, and so forth. So from that perspective, there are other pieces of our proposal which we think are absolutely critical that would still apply to those firms that chose no longer to be bank holding companies.

On the international dimension of your question, Senator, again, I think we are working closely with our G-20 partners to make sure that we get a regime that works worldwide so that we do not have new opportunities for arbitrage. I think as the Chairman said very eloquently, it is important for us to lead in that effort, and we are leading. And at the end of the day, again, I think that for us to have a strong regulatory regime is in some sense the most important competitive advantage that we could create because capital will want to flow where it is going to be protected and safe and where the overall framework is one that can be relied upon.

Senator JOHNSON. Chairman Volcker or Secretary Wolin, it is my understanding that the Federal banking regulators already have the discretionary authority to impose activity restrictions right now very similar to what would be mandated by the Obama proposal. The Fed may require a bank holding company or a financial holding company to terminate any activity or divest control over any subsidiary that has a reasonable belief that constitutes serious risk to the financial safety, soundness, or stability of a subsidiary bank on a firm-by-firm basis.

Do you believe that the Fed has this authority? Are there specific examples in the last 2 years where you think they failed to use this authority?

Mr. VOLCKER. Well, I have no doubt that they need further instruction from the Congress, if I can put it that way. I do not know, I have been too far removed as to what authority the Federal Reserve would have to prohibit some activities. Some of these activities—most of them are provided for in law, and the law says a

bank can do so-and-so. I do not think the Federal Reserve can lightly say, "I do not care what the law says. You cannot do it."

They can have general concern about safety and soundness and, within limits, I think they can say, "You are conducting a particular activity in a very risky way and do not do it." But I am not sure they can say you cannot do proprietary trading; the law permits it. I think they need further instruction.

Senator JOHNSON. Mr. Wolin?

Mr. WOLIN. Senator, I think the Fed and the other regulators do have a broad set of regulatory authorities to act in circumstances where they think safety and soundness is at risk. Our proposals suggest those authorities ought to be clarified and strengthened. But in these three areas, we believe that it should not be left up to the discretion of the regulator; that if you are going to get the benefit of the safety net that banks and banking firms enjoy, you should not be allowed to do these three activities which are riskier and would get the subsidized benefit in effect of that access to the safety net.

So we think it is important for the regulators to have even stronger authorities to act in a discretionary way to make sure that when they see something in a firm or that is broader, that they can take appropriate action. But this ought to be hard-wired, in our view.

Senator JOHNSON. What are the benefits of restrictions of activities on a wholesale basis instead of restrictions on a firm-by-firm basis?

Mr. VOLCKER. I think you want some consistency over the industry, is all I would say about that. I do not think you want to say Firm A can deal in this business and Firm B cannot.

Now, you might because of particular circumstances have some reason to think Firm B is taking extreme actions that are not creditworthy, and so you say, "Stop it," because they are going overboard. But I do not think you can say they do not have the same authority to take action that another bank does.

Senator JOHNSON. My time is up.

Chairman DODD. Thank you very much, Senator.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman. Thank you both for being here. I appreciate it very much.

In your written statement, Secretary Wolin, you said we should limit the ability of financial institutions to get bigger. That is in your written statement. But, Chairman Volcker, you do not address the size of firms in your statement. Do you agree with Secretary Wolin that we should limit the size of financial institutions? And if so, what limits would you put or should we set?

Mr. VOLCKER. Well, I have not been involved with these discussions directly, but I think there is a kind of common-sense feeling that at some point a financial institution, and particularly a bank, is so large in comparison to the whole market that it raises questions not just of stability and failure but of competition. And the United States is a very big market, and as I indicated earlier, at one point we thought a 5-percent restriction might be appropriate, and then it became 10 percent.

Senator BUNNING. I was on the Committee.

Mr. VOLCKER. And now it is becoming higher, I suspect. You know, there is nothing magic about a particular number, but there is some point where it makes me feel uncomfortable if it got too big. Now, what that point is, I think you have got to decide.

Senator BUNNING. Would you like to respond?

Mr. WOLIN. Please, Senator Bunning. Thank you. I think this is an important question, and let me try to clarify what we are proposing and what we are not.

We do think that there ought to be a limit on relative size, that is to say, in proportion to the overall size of the system.

Senator BUNNING. Overall.

Mr. WOLIN. What we do not want to do is constrain or have this bind on the current size of firms, that is to say, firms would not have to shrink, so it is from further growth. And it in our view does not and should not apply to organic growth, meaning like the 10-percent deposit cap, it ought to apply in circumstances where you jump over the size limit through acquisition. Again, we have to work on what that size limit should be, but at the end of the day, it is our view that there is important correlation between size and riskiness of firms. It is not the only thing, but at some point firms get to be so big that they do impose a risk on the system.

Senator BUNNING. Let me follow up on your statement because you said that we need to stop larger financial institutions from getting bigger, and then you just have said that we should not try to shrink them. Is that correct?

Mr. WOLIN. That is right.

Senator BUNNING. But these firms are already too big to fail, and the last 2 years have shown that at least in the judgment of the Federal Reserve and Treasury that is the case. Why should we not force them to get smaller in addition to stronger regulations? How does letting a firm that is already too big to fail stay big, how does it solve the problem?

Mr. WOLIN. Senator, I think that is an incredibly important question. I think two basic responses.

We do have in our proposal a series of elements that we think create positive economic incentives for firms to shrink: heightened capital standards, leveraged constraints, liquidity requirements, all of which will create economic incentives in the direction that you are talking about. So this is, again, a set of proposals that build on one another and no one of them is the entire answer.

So I think, you know, the other part of it, of course, is we do agree that it is critically important that resolution authority be adopted so that we do not have this horrible choice between having firms fail with tremendous knock-on consequences to the broader system on the one hand, or having to make the taxpayer foot the bill on the other, so that firms are essentially put out of their misery, or our misery, in ways that accomplish that goal but do so in an orderly fashion. I think those would be the basic answers.

Senator BUNNING. Senator Johnson brought this up on regulations. You know, the Congress has acted on regulations. In 1994, we, by regulation and by law, gave the Fed the authority to regulate banks and mortgage brokers. We gave them the power. We did not force them to use it. So for 14 years, they sat on their hands and did nothing.

Now, how do you propose in your proposals to force the regulator to act?

Mr. WOLIN. Well, I think, Senator, that is obviously critically important. I think the statute should lay out that this is what the law should be and then—

Senator BUNNING. We did that.

Mr. WOLIN. Well, I think, you know, we have all learned a lot of lessons through this.

Senator BUNNING. I know, but 14 years is a long time before you rewrite one rule.

Mr. WOLIN. It is indeed.

Senator BUNNING. You know, and so all I am saying is that we can do those wonderful things that you are proposing. We cannot force the regulator to enforce it. And I want to make sure, if we do overhaul our financial regulatory regime that there is guts in what we do.

Mr. WOLIN. So I think, Senator, one of the ways in which you can have confidence that that would happen in the proposals that we have put forward and with which we are working with the Committee is to have a council, to have a group that has political accountability, including to the Congress, and, you know, I think that is the way to make sure that the will of the Committee and the will of the Congress overall is moved forward. We certainly take that very seriously.

Senator BUNNING. We also have to have really basic standards that the financial institutions have to meet. You know, we talked about all the things that are non-bank bank activities. Well, if they are non-bank bank activities, only non-bank banks should do them. And when we get into proprietary trading and we get into other—Chairman Volcker, you said that it is OK for banks to package mortgages. Wasn't that at the heart of our crisis? I know we are looking back, and I want to look forward to prevent it.

Mr. VOLCKER. Well, certainly the whole mortgage market was an important problem here, and the banks were participating in that, and they were doing things that I think contributed to the problems of the mortgage market. But this gets into other areas. We do want a mortgage market. We do want to make mortgages available to the people so we are—

Senator BUNNING. We are having problems right now with that.

Mr. VOLCKER. Absolutely. We do not want to prohibit people from making mortgages. I think one of the proposals within the Administration approach—and I think it is in the House bill—is that when a bank or other institution packages securities, whether they are mortgages or otherwise, and sells them in a package, they keep part of the package themselves, which was a discipline, I think, that was missing—

Senator BUNNING. I think that is a great idea. Yes, then they share the risk.

Mr. VOLCKER. Right.

Senator BUNNING. My time has expired. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Reed.

Senator REED. Thank you, Mr. Chairman. I thank Chairman Volcker and Mr. Secretary.

There are lots of institutions now at bank holding companies. The investment bank model would seem to be a footnote in history. But when you go on the street, very few of them are performing like banks, in the populist sense of a bank, which is to take deposits and provide safe return, and also to make commercial loans, residential loans, and consumer loans.

My sense is that the essence of your proposal is not simply to prevent proprietary trading but, more importantly, to get them to start acting like banks again.

Mr. VOLCKER. Yes.

Senator REED. Which is to make commercial loans, to make consumer loans, to make residential loans.

Mr. VOLCKER. I do not want them to be diverted from those activities.

Senator REED. And I wonder, Mr. Chairman, can you—and you have, but can you once again sort of stress how this proposal would focus them on those activities?

Mr. VOLCKER. Well, I think the only answer I have to that is it focuses on those activities by removing the temptation to get highly involved in more speculative type of activities where the immediate returns may seem to be very high and you have got some very highly paid people who want to keep that kind of activity going. I think commercial banks, I would like to understand their basic role in the scheme of things that you just outlined and concentrate on it.

One thing I might just add, it is a complication at this time, I apologize, late in the afternoon, but there is a question about money market mutual funds, that they originated in a kind of regulatory arbitrage some years ago because they did not have to put up with some of the restrictions that banks put up with, and they have attracted trillions of dollars. And if more of those dollars were in the banking system, I think the incentive to lend, whether to businesses or homeowners or whatever, would be greater. That is an area where the Administration has made some proposals, and I think it ought to be taken seriously.

Senator REED. Well, I appreciate that point and it is well made. I think, again, returning to this issue, when I go and I think when my colleagues go back to their homes, people are saying, “I cannot get a loan. I have got good credit.” Or, “They have just cut my line of credit in half and raised the interest rates by 10 or 12 percent at the time the cost of funds is close to zero.” And some of that is covering, as you suggest, Mr. Wolin, the losses in other types of activities, or I think some of it is because they can take that low-cost money, put it into these types of proprietary activities to make a much larger return. And if you are a business person, that is what you go. That is how you get a big, big bonus.

Mr. VOLCKER. Of course, that reaction became extreme in the middle of the crisis a year or more ago, and nobody wanted to move any money anyplace. I hope that is changing some. There is a little evidence from some banker survey that the Federal Reserve made that they may be less tight than they were. But this is partly a matter of the severity of the economic crisis, and a lot of loans went

bad and they are cautious. And we want to do what we can to increase confidence and get the money flowing.

Senator REED. Let me ask you if there is another way to approach this concept, which is to say to an institution if your traditional commercial banking activities are less than 75 percent, then you do not have access to the Fed window. I mean, essentially what my colleagues have said time and time again, we do not want to subsidize the risk. We do not want the bailout. Well, the bailout comes, as we have seen, particularly in the context of bank holding companies, when the Federal Reserve walks up and takes whatever collateral they are willing to give them and gives them lots of money.

Mr. VOLCKER. It is an interesting idea. I have not thought of it, I must confess. It is the reverse of many other ideas that you withdraw support if they do not lend enough. The Deputy Secretary mentioned some things that kind of discourage growth and would encourage, I hope, lending. But I would have to think pretty hard about the suggestion of removing, in effect, the safety net from banks that did not act like banks.

Senator REED. Well, food for thought.

Mr. VOLCKER. OK. We will look at it.

Senator REED. Secretary Wolin, do you have any comments?

Mr. WOLIN. I think it is an interesting idea, Senator Reed. I think we want to be careful. Obviously, the safety net is incredibly important related to this utility function that banks play for individuals, for small businesses, for everyone, and so I think we want to be careful about unintended consequences on that, but it is something for us to work with you on and give additional thought to.

Senator REED. I mean, this has been described variously as the Fed put, which is basically we can go out, take some risk, and then we go to the—there is some way to put the risk off onto the Fed, which ultimately is the taxpayer. But I think, again, I think we have to think about a way that not only gets banks into what we think is the banking business—making loans and taking deposits—but also—and my colleagues have said this several time—is something that does not require a battalion of regulators constantly making judgments about is this a proprietary trade or is that a proprietary trade, *et cetera*.

So, again, I think your proposal is something that deserves very thorough thought and also think of other ways that might be implemented. Thank you.

Chairman DODD. Senator Reed, thank you. That is a very creative idea. My experience has been over the years, as we have this debate and discussion about what is proprietary trading and how you define it and limit it, that there is probably some 22-year-old sitting in the bowels of some institution that has already figured six ways to get around anything we can write here. That has been my experience over 30 years, and that we will end up passing a law, and we will turn around, and there is a whole new creative idea, using the genius of those creative ideas to create wealth and to expand opportunities, what we ought to be talking about, instead of trying to figure out how to get around a rule or a regula-

tion. So, Jack, your idea, the beauty of it is that it achieves the goal without getting terribly complicated.

Senator REED. I grew up the where the rule was KISS, Keep it simple, stupid. And I think that is——

Chairman DODD. Not a bad rule for the Congress.

Mike Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman. I want to follow up on that and a number of the other questions that have been asked in the hearing today, and that is the detail. The Administration submitted a significant proposal last summer about how to approach reform of issues in the financial world. The Volcker rule was not in that proposal last summer. I assume that part of the reason that we did not have it was because it was a legislative proposal that did not have—and that we do not have the detail yet for the legislation language as to how to actually make the definitions. And my question, Chairman Volcker, is: Drawing bright lights between the permissible and impermissible activities on market making or customer facilitation or proprietary trading is going to be very difficult, and some people say impossible or unworkable.

If the Government makes it too difficult for banks to take positions, then there will be less liquidity in the market and the corresponding impacts on capital formation and robust economic activity.

Do you expect that we will receive some specific legislation language so that we can understand specifically what we are talking about or what the proposal is with regard to proprietary trading and the other details of what is being discussed here?

Mr. VOLCKER. I think that is Mr. Wolin's responsibility. I delegate——

Senator CRAPO. So you talk to us, you give us the theory, right, and Secretary Wolin will give us the detail?

Mr. WOLIN. Senator, I think an important question, obviously. Like the other proposals that we first articulated in June in the form of our White Paper, we will send draft legislative proposals to the Committee for your consideration. I think on these things, like on lots of other pieces of our proposal, we will want to embed in statute the principles that we have articulated with some detail. But, again, like an awful lot of banking law and a lot of the proposals, lots will be left to the regulators to implement in very detailed ways. So that is really the process forward.

We are keen to work with you. We are currently working internally with the regulators to craft language that you can consider and that we would want to work with you on, obviously, as you move forward.

And then inevitably on these kinds of things, making judgments at the margin, trying to figure out how to implement the principles in particular contexts is what regulators do in really the full range of banking laws that are on the books or that are being proposed in this current discussion.

Senator CRAPO. I understand the difference in role between policymaking and then the regulatory interpretation, although there is always a conflict there, a push and a pull or a tug in terms of what kind of specificity we need. But am I to understand you, Mr. Secretary, to be saying that you would expect Congress to pass leg-

islation implementing the idea, but that we would not really have a good feel for what proprietary trading means when we pass this legislation?

Mr. WOLIN. No, no, Senator. I am sorry. I did not mean to leave that impression. I think we would want to specify it and have a role that is clear that regulators could then implement, but inevitably, in the same way that exists currently with respect to capital standards or a range of other questions that exist currently in Federal banking law or that would be enacted in Federal banking law in the proposals that the Committee is currently considering, certainly a lot of the detail would be left over to specific application in the rulemaking process or in the supervisory process.

Senator CRAPO. So we can expect some significant further detail from the Administration on exactly what it means by these proposals.

Mr. WOLIN. Senator, I expect that we would give you the same sort of language on these proposals as we have on the other proposals that we have put forward at the same level of detail and specificity. We really think of it as very similar in those regards.

Mr. VOLCKER. If I may just interject, Senator.

Senator CRAPO. Yes, go ahead.

Mr. VOLCKER. Bankers know what proprietary trading is and what it is not, and do not let them tell you anything different.

Senator CRAPO. Well, you know, I suspect that that may be true to some extent, although I also suspect we could find different points of view among bankers as to exactly what we are talking about. But I think the real question here is what the law says, and that is going to be pretty critical.

Mr. VOLCKER. I agree, if your question is what the law says, and I do not think it is so hard to set forward the law that establishes the general principle, and that is going to have to be applied in difficult circumstances. The Chairman spoke about the banks are all going to have a lot of 26-year-olds who have a lot of fancy mathematical training and all the rest. The supervisors need a few 28-year-olds that have had the same kind of training.

Senator CRAPO. Well, I can say—and I understand the point you are making, but I can also tell you that I think that this Committee and this Congress need some level of specificity on which to act with regard to these proposals because if we get them wrong, I think that we could be doing as much damage as good.

Mr. Secretary, do you have any idea when we could get this detail?

Mr. WOLIN. We are working on it hard, Senator Crapo. I think, you know, in short order. I do not want to define exactly how many days or weeks, but it is going to be soon. We understand that you all are busy putting legislation together, and we want to make sure we get you language that can be timely in the context of the process that you have outlined.

Senator CRAPO. All right. Thank you. I would like to, in the short time I have remaining, just shift gears to our GSEs, Fannie and Freddie.

In January of 2010—and this is probably mostly for you, Mr. Secretary—the CBO background paper on budgetary treatment of Fannie and Freddie states,

CBO believes it is appropriate and useful to policymakers to include their financial transactions alongside all other Federal activities in the budget.

The Administration, however, in its recent budget submission has not chosen to do that and has not chosen to bring the GSEs on budget.

Could you explain to me why that is the case?

Mr. WOLIN. Senator, I think the GSEs are not owned by the U.S. Government. They are under the conservatorship of the FHFA. I think there is some amount of discretion that could be used. We tried to be transparent as we laid out the financial circumstances of the GSEs. Certainly the FHFA has been transparent. I understand they have sent a letter up to the Committee as recently as today laying that out. In our budget documents, I think there has been a high degree of transparency, and whether or not it was consolidated onto the balance sheet of the Federal Government.

Senator CRAPO. Well, I understand that, but we are talking about CBO's estimate of \$291 billion, and that is a pretty big difference in the budget documents, depending on whether it is included or not. And the only thing the Administration said in the proposed budget was that the Administration continues to monitor the situation of GSEs closely and will continue to provide updates on considerations for longer-term reform of Fannie Mae and Freddie Mac as appropriate.

So I guess a two-part question still: Is the Administration going to account for that \$291 billion in its budget discussion this year? And, second, when will we get details on what the Administration's proposal for the GSE reform is going to be?

Mr. WOLIN. Senator, again, on the first question, we have laid out in our budget documents the transparency of the financial circumstances related to the GSEs. I think the question of consolidation is a question frankly of whether we own the GSEs or do not. We do not own them. The FHFA is a conservator of them. So I think that was the judgment made there.

In respect of the policy with respect to the GSEs going forward, obviously we are very focused on the stability of the housing markets. We are looking at long-term options for the GSEs, and as we said in our White Paper, when we have that we will certainly bring forward our recommendation. It is clearly a critically important set of things for us to be focused on, but we want to do that in the context of stability in those markets and make sure that especially at this critical moment we do not do anything with respect to their long-term future that would perturb that stability.

Senator CRAPO. Well, thank you. I personally think that we need to see that \$291 billion better reflected in the budget analysis that we are going through right now, and I do look forward to continuing this discussion on the details of proposed GSE reform.

Thank you.

Chairman DODD. Thank you, Senator Crapo.

Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman. Thank you for holding the hearing. I thank the witnesses. Sorry—I have been busy with a million different things—that I came in at the very end. Better late than never, I hope.

I want to thank you, Mr. Volcker, for your thoughtful proposals, particularly relating to the too big to fail issue. I remain convinced that the steps the government took to save the financial system were absolutely necessary, but I suppose like everyone in the room would prefer we never be in that situation again and agree with the premise at the heart of your proposal: The safety net provided by the government put in place over the last century in response to multiple banking panics not be put at risk by financial activities that are outside the core function of the banking system. That would be a summation of what you—

Mr. VOLCKER. That is the core.

Senator SCHUMER. Yes. OK. So now I would like to ask a few questions to help us understand and probe it. From what I am told of the questions here, there is still a lot of trying to drill down as to what exactly we are talking about.

I would like to talk a little bit about Canada and use it by way of contrast. They have a banking system, as you know, dominated by six large full-service banks, but it was the only G-7 country where the government didn't have to bail out its banking system in the recent crisis. Some people say it was cultural, arguing Canadians are simply more risk averse as a society than Americans and their bankers are no different. But others have argued the answer had more to do with their regulatory system. I tend to believe that. I don't know exactly how it works, but I know enough culture, maybe were the British more risky than the Canadians culturally? Who knows. But this regulatory system, and particularly its willingness to just say no to risky practices.

So here are my specific questions and then general. Consumer protection—Canada has a separate Consumer Protection Agency, and despite home ownership levels higher than the United States, the percentage of Canadian mortgages that are subprime is less than half of that in the United States. The default rate is less than 1 percent in Canada compared to 10 percent in the United States. What role do you think Canada's Consumer Protection Agency played in maintaining a safe and robust mortgage market and not allowing billions of dollars of no-doc loans to just be stamped, stamped, stamped, and securitized?

Mr. VOLCKER. Well, I can't answer your question because we don't know. But one characteristic of the Canadian market is kind of interesting to me. It is essentially much more a privately owned market, so to speak, than the American market. They don't have the equivalent of Fannie Mae and Freddie Mac and the kind of volume that we have. They haven't had the pressure, frankly, from the government to push out very low downpayment mortgages. The market is pretty much dominated by commercial banks—

Senator SCHUMER. Right.

Mr. VOLCKER.—which is no longer true in the United States, and they have had, I think, an incentive to stay with more conservative practices in their own interest.

Senator SCHUMER. What was the incentive? Why did their—let me put it another way. Why would their banks have the incentive and our banks not have the same incentive?

Mr. VOLCKER. Because our banks were out of the mortgage market, basically. They were selling—all these mortgages were getting

packaged and sold to Fannie Mae and Freddie Mac and there aren't so many mortgages left, residential mortgages left on American banks. That is——

Senator SCHUMER. Right.

Mr. VOLCKER. I think that whole thing deserves some kind of review, because the American mortgage market today is broken. There is no doubt about it.

Senator SCHUMER. Right.

Mr. VOLCKER. And you have got to rebuild a strong mortgage market, and I think looking at——

Senator SCHUMER. You don't think the Consumer Protection Agency—I mean, I think if we had a Financial Consumer Protection Agency, it wouldn't have allowed a lot of the practices that we saw that, frankly, came initially not from banks, but from mortgage brokers.

Mr. VOLCKER. I just am personally unfamiliar with that.

Senator SCHUMER. I see. OK. So you are neutral on that issue. And what about securitization?

Mr. VOLCKER. Well, I think——

Senator SCHUMER. Twenty-seven percent of Canadian mortgages are securitized, compared with 67 percent of U.S. mortgages. Now, do you think that——

Mr. VOLCKER. What percent in Canada?

Senator SCHUMER. Twenty-seven in Canada, 67 in the United States.

Mr. VOLCKER. Well, that is a reflection of what I said. The mortgage market in Canada is still in the kind of traditional banking market. Now, their mortgages are in shorter duration. They haven't got all the favorable arrangements for mortgage we do. They are not—they have no tax advantages.

Senator SCHUMER. Right.

Mr. VOLCKER. They have prepayment charges and that type of thing. So they are in a different mortgage market. We ought to learn from them, maybe—not maybe. I think we ought to. It is a different—it is a less government-dominated mortgage market.

Senator SCHUMER. Do you think the securitization is also related to the Fannie and Freddie guarantees?

Mr. VOLCKER. Oh, there is no question that Freddie and Fannie——

Senator SCHUMER. Do you agree with that, Mr. Wolin?

Mr. WOLIN. Yes.

Senator SCHUMER. So if we didn't guarantee as many mortgages, there would be less securitization. I don't know about that. We securitized everything here, not just federally guaranteed stuff, and not just mortgages. Everything got securitized. Credit card loans got securitized

Mr. VOLCKER. That is right.

Senator SCHUMER.——without any Federal guarantee.

Mr. VOLCKER. That is correct, but I think it is fair to say——

Senator SCHUMER. My guess is if you compared the Canadian banks on credit cards, their rate of securitization would also be considerably lower.

Mr. VOLCKER. I suspect so. I don't know, but I suspect so.

Senator SCHUMER. And that would have nothing to do with Fannie and Freddie.

Mr. VOLCKER. There are a lot of differences between Canadian banks and American banks. As you said, they have only five or six major banks, heavily engaged in retail banking.

Senator SCHUMER. Right.

Mr. VOLCKER. Their life's work is retail banking. That is no longer true—it is true of some American banks, but none of the great big ones.

Senator SCHUMER. It was a little true of B of A before they—

Mr. VOLCKER. That is right.

Senator SCHUMER.—before two or 3 years ago, right?

Mr. VOLCKER. That is correct. And they have—because there are so few, the competitor situation is quite different because it is a stable oligopoly.

Senator SCHUMER. Right. Any other lessons you might draw from the Canadian situation?

Mr. VOLCKER. I think they have been more conservative in regulation. That is my impression of their supervision. But there, the central bank is not the chief regulator.

Senator SCHUMER. Right.

Mr. VOLCKER. It is like the British. But some years ago—not recently, but some years ago, they got in trouble when two of their major regional banks did go bankrupt.

Senator SCHUMER. Right.

Mr. VOLCKER. At that point, people were not so proud of the regulatory system in Canada.

Senator SCHUMER. Right. So another question, the inverse of this question. Here, you had Canada, big, big banks and relatively secure. Just because an institution is small doesn't mean it is not risky, and I would argue these days doesn't even mean they don't pose systemic risk. Maybe one hedge fund doesn't, but if 50 hedge funds do the same thing, together, they pose a problem of systemic risk if it is a risky activity. And with all of the counterparty risk and the intertwined spaghetti-like nature of the financial system, I mean, even back a while ago, whatever the place was in Greenwich, long-term—

Mr. WOLIN. Capital Management?

Senator SCHUMER.—Capital Management wasn't that large a company, but if the Fed didn't heavily intervene and get other people to prop it up, we might have had the whole system unraveling.

And so I guess the question I am getting at on both ends of this, isn't it—or I don't want to even put it that way. It is the riskiness of the activities that the financial institutions do as much as their size that matters, or would you not argue that? In other words, because—just take my example, a risky activity done by one hedge fund or one small investment bank doesn't shake up the system, but if 50 of them are doing it, it does, particularly with counterparty risk. So that is my last question. Could you each comment? Neal?

Mr. WOLIN. I think it is mostly factorial. So size is clearly related. Interconnectedness is related. The riskiness of the activity is related. And so it is some combination. I think our proposals are meant to address each of those things in various combinations, but

we do think that size at some level, above some threshold, is an important indicator of risk to the system, but it is absolutely true, Senator, that there are other elements to that equation.

Senator SCHUMER. Yes, and you could clearly say one large institution doing risky things poses a greater systemic risk than one small institution doing—

Mr. WOLIN. Absolutely, Senator.

Senator SCHUMER. Go ahead.

Mr. VOLCKER. You are touching, I think, on a very big question of contagion, that institutions who are not in trouble necessarily and may be in a reasonably stable position are no longer stable if other people are failing and there is kind of a panic.

Now, the answer to that in terms of hedge funds and equity funds and so forth is they are less likely because of the method of financing. You don't withdraw short-term money from hedge funds and equity funds because they typically don't take short-term money. They largely take equity money. And that is a very different situation when it comes to the effects of a kind of panic spreading around.

Senator SCHUMER. Well, I know on that fateful week, and Chris was there, the worry was these people with short-term paper would just withdraw it from all these large institutions, and I guess that is right. It couldn't happen from most of the smaller institutions because their capital was longer-term.

Mr. VOLCKER. It happens with the slow—

Senator SCHUMER. A very interesting point. Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman, a great deal.

Mr. Chairman, Mr. Secretary, thank you. Mr. Chairman, I want to reiterate, as you visited me earlier today and looking at the pictures of famous New Jerseyans in my outer office, that I welcome you to send us a picture and we will hang it up in the outer office along with all the other famous—

[Laughter.]

Senator MENENDEZ. Born in Cape May, New Jersey. Married a Jersey girl. That is about as Jersey as you get, so—

Mr. VOLCKER. It depends upon how this legislation comes out as to whether I want my picture up—

[Laughter.]

Senator SCHUMER. Where did you live longer? In which State did you live longer?

Mr. VOLCKER. Uh—

Senator MENENDEZ. Well, since he is eating up my time, you can take—

[Laughter.]

Mr. VOLCKER. I have lived longer in New York, I think.

Chairman DODD. But you wish you lived in Connecticut.

[Laughter.]

Mr. VOLCKER. I wish I lived in Connecticut. Exactly.

[Laughter.]

Senator MENENDEZ. All right. Well, the offer still stands.

I am reminded at the mantle of the Archives Building it says, “What is past is prologue,” and it seems to me that a lot of people want to dance around here, but at the end of the day, if we don’t act, we are destined at some point in the future to relive a crisis, and that would be the worst situation perpetuated on the American people. So I think this is incredibly important.

In the wake of the financial crisis, the surviving banks have actually grown bigger, not smaller, and the Volcker Rule doesn’t force existing banks to downsize. So does that mean that you are comfortable with the current size of the banks that still exist?

Mr. VOLCKER. Well, I am not terribly upset by it. I think there are limits. We discussed earlier common sense limits as to how much of a concentration you want in banking, and I have sympathy for what the Administration is trying to figure out, a sensible kind of limit that doesn’t put a hard cap on organic growth of a bank but does say, look, if you are already very big, you can’t combine with something else that is very big. I think these very big banks, they are able to take care of themselves.

Senator MENENDEZ. Isn’t one of the risks here—I have posed this question throughout some time now of these hearings—that if you are too big to fail, haven’t we failed already, because it presumes that your consequences to the economy are such that we can’t let you fail. But that also produces the environment for risk taking that shouldn’t take place.

Mr. WOLIN. Senator, I think it is important. I think from our perspective, the size cap is one of the two elements of what the President announced a few weeks back. It is not the only piece of our proposals that deal with size. By asking for higher capital standards, liquidity requirements, leverage standards, and so forth, we do create positive economic incentives for firms to shrink and believe that that is done in the context of making sure that all of those standards are really focused importantly on making sure that firms individually and the system in the aggregate is not overly risky, so that those things are tethered, the economic incentive to get smaller and the buffers, the cushions, the extent to which the firm can be more resilient at moments of distress are interlinked.

Mr. VOLCKER. There is another point here, if I may add to that answer. With the resolution authority, which you haven’t brought up, what seems too big to fail today may not be too big to fail tomorrow because you have a better arrangement for putting that institution to sleep without disturbing the whole market. That is the whole purpose of this resolution authority, to handle big failures.

Senator MENENDEZ. Now, it seems to me that one of the—asking whether proprietary trading played a role in this crisis is missing the biggest lesson of this crisis, which is how do you avert the next one. And we know proprietary trading can be dangerous and contribute to the downfall of some investment banks. Mr. Chairman, you talked about not having taxpayer support for speculative activity. So it just seems to me that we should be attributing that to commercial banks, as well, so that we, at the end of the day, can ensure that customer deposits don’t end up being part of the speculative nature that can create a crisis. So that is, in essence, what you are trying to do here.

Mr. VOLCKER. But, in essence, that is what we are—

Senator MENENDEZ. Now, with that, if we pass a law preventing commercial banks from engaging in proprietary lending, one possibility is that a Goldman Sachs or a J.P. Morgan will simply drop their bank holding company status and continue to engage in proprietary trading, hedge fund, private equity activity. If they do that, will our financial system be less systemically at risk?

Mr. WOLIN. I think, Senator, whether they choose to be a bank holding company and engage in banking activities, or whether they choose instead to engage in these riskier activities, the full range of supervisory constraints and prudential standards that we think need to be tough and heightened will still apply. And so from that perspective, we will still be well covered in the proposals that we are putting forward.

I think what we will have additionally is not having these risky activities be subsidized, in effect, in circumstances where a firm has, because of its access to the safety net, essentially a lower cost of funding and advantages that are in some sense helping them to focus on and engage in the activities that we are concerned about.

Senator MENENDEZ. So the Volcker Rule alone, if we are concerned about more broad systemic risk outside of even banking institutions, needs to have it be augmented by some of the other proposals—

Mr. VOLCKER. Absolutely.

Mr. WOLIN. No question about it. Absolutely, Senator.

Senator MENENDEZ. And finally, Mr. Chairman, you have said, Mr. Chairman, that there is, quote, “not a shred of evidence that financial innovation has improved our economy,” and, in fact, that innovative financial products, quote, “took us right to the brink of disaster.” Why do you believe that financial innovation got so out of control, and can regulators, as the Chairman and the Committee deal with financial regulatory reform, can regulators ever be in a position to keep pace with innovation? And if not, are there steps we should take to make banking an innovation, you know, subject to the ability to ensure that it doesn’t get out of control?

Mr. VOLCKER. Look, there is no assurance in this area, but part of what I hope is the effect of what we are proposing is to reduce the capacity of the banks through imaginative financial engineering techniques to get way ahead of the regulators, because the most fertile field for this is in the area of hedge funds, equity funds, and proprietary trading. It doesn’t mean they can’t do a lot of complex things in the more traditional banking area. But at least you have cut down to some extent the risks of which you speak, quite rightly.

And I do think the supervisory agencies are going to have to be better staffed. I think some of them are pretty well staffed now, but they are going to have to have the funds and the interest and the capacity to attract some of the brightest and best financial engineers, too. It takes a thief to catch a thief, so to speak. So there is a lot to be done in that area, I think.

Senator MENENDEZ. Mr. Secretary, do you want to comment on that?

Mr. WOLIN. Senator, thank you. You know, I think financial innovation is incredibly important to our economy and to people in businesses across the country. The critical question from our per-

spective is that that innovation happen within a robust framework of consumer protection, firstly, and that, second, that the taxpayer is not on the hook for when those innovations go sideways, that the funds themselves bear the downside risk of, in effect, failed innovation.

So we want to make sure we have a system in which we have lots of innovation in this sector. That is hugely important, I think, to our entire country and to our economy, but incredibly important that it be done within those two critical frameworks.

Senator MENENDEZ. So innovation in which the innovator bears the risk?

Mr. WOLIN. Exactly, Senator.

Senator MENENDEZ. Thank you. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Just a couple of thoughts, if I can, picking up the question that Senator Menendez raised. Some have raised the issue that supposing an investment bank, using the examples where they would get rid of holding companies and so no longer at least would be defined accordingly, but since they were at least once covered by the safety net, should we worry that it would still be viewed as being protected, and as such, that it would act as if it were?

Mr. VOLCKER. Absolutely. I think that is the big problem you face. Having been protected once, they will expect to be protected again. And more important, their creditors will expect them to be—

Chairman DODD. Well, that is what I am getting at here.

Mr. VOLCKER.—protected. That is why I think you have got to be very tough in legislative language with this resolution authority, that the resolution authority is not a safety net.

Chairman DODD. No, I agree.

Mr. VOLCKER. It is a—

Chairman DODD. I am not going to write—I mean, we are working on the bill, as you know and you have heard now for a number of months here, trying to pull this together. And I am hesitant to tell you what is going to be in the bill or not in the bill. But one thing that seems to be emerging you heard today is a very, very strong proposal dealing with resolution authority. And clearly, the notion of too big to fail, as I have said repeatedly, should become historic terms, and that bankruptcy receivership is the way these things will end up and will leave an opportunity for resolution, but that would be such a painful road to go down that there would be enough incentives to discourage people from opting for that solution.

And the question, I guess, is, as you suggested, I think an awful lot of that will do an awful lot of what we are trying to achieve. That notion of being bailed out, if you will, is going to be absolutely off the charts, and to the maximum extent possible. So euthanasia, to use your word, Chairman Volcker, while that is not a legislative term, it is exactly what we are trying to achieve here. And that, I think, goes a long way.

I am probably in a minority of one on this Committee, but I, for one, have been always attracted to the idea of the principle-based system rather than a rule-based system because I think it just gets to the heart of the matter in so many better ways than sitting to

write specific rules all the time with the full knowledge that every time you write one, there is someone trying to figure out how to get around it. It is a game you never, ever catch up on, whereas a principle-based system, I think, gives a lot more leverage and authority to the regulators. But that is a separate debate for a later time.

Let me just also suggest to you here, and I say this primarily to you, Secretary Wolin, and to a lesser degree to Chairman Volcker, we are in the process—we are going to get something done here now. I have gone—we have had over 52 hearings this year. I can't tell you the countless meetings I have had with Members of this Committee. This represents one-quarter of the U.S. Senate on this Committee. And I have had endless meetings with people on the various aspects of this bill. It is not a movable feast. It is not one that I can add ideas to it on a weekly basis and expect to get this done.

And while I have certainly been familiar with the issue of dealing with proprietary trading and other issues, it does come up late, and the idea that the Administration made this such a major point a week or so ago seemed to many to be transparently political and not substantive and it is adding to the problems of trying to get a bill done.

Now, there are other ideas that clearly should be a part of this, but there are tipping points. There is only so much that this institution will tolerate in a given point of time. I have been around it long enough to know what happens if you try and do more and bite off more than you can chew and we are getting precariously close to that. And I don't want to end up in a day here, well, because these ideas, many of them—and this is one, I said to you, I like the idea, either this variation of it or what Jack Reed suggested or something along these lines. But I don't want to be in a position where we end up doing nothing because we tried to do too much at a critical moment.

So I want you to know that, because it is important from the Administration's standpoint. We are getting late in this game now. We need to do this right and do it carefully, and I have been trying to do that, and I want to do it if I can on a bipartisan basis. I don't want to go to the floor of the U.S. Senate begging for a 60th vote. I am not going to do that. So I want you to know that as we go forward. So if you have got more ideas, let me know.

[Laughter.]

Chairman DODD. And let me know in a timely fashion. And also, when we call down and say, how does it work and specifically what do you have in mind, I expect answers to the questions. And we have made the calls and we are not getting good answers.

Mr. VOLCKER. Well, let me just respond a little bit, if I can. And it is really important, I think, to get this right. And if you don't do it in the first round, God knows when the second round—

Chairman DODD. I don't know, either, but, you know, you can't add stuff every day to me on this—

Mr. VOLCKER. It is important that we have a little chance, or you have a little chance, I think, to see what direction the British are going in and the French are going in and so forth. And the idea that this comes down to some party vote or 60 votes or something,

I don't think is right in this area because it is obviously not a partisan issue.

Chairman DODD. Yes.

Mr. VOLCKER. But let me just say, for the record, I read all this stuff that the President's announcement was political. It came after Massachusetts. I know personally he decided this some weeks before and he had been discussing what day to announce it long before—before Massachusetts, and it was just a sheer coincidence that this thing came out on Thursday after—

Chairman DODD. You and I know that, and Members of the Committee know that.

Mr. VOLCKER. I just want the public to know it.

Chairman DODD. But it doesn't—I mean, and we also—but also, as I say, it looks in a way—sometimes these things are announced don't help.

Mr. VOLCKER. No, I understand.

Chairman DODD. And I make recommendations and so forth as to how to do this stuff and then it falls on deaf ears, and so we end up in the situation where I am grappling around here trying to convince people there is a substantive idea here that needs to be tangled with.

Mr. VOLCKER. We will convince as many as you can to help you out.

Chairman DODD. I appreciate that.

[Laughter.]

Mr. WOLIN. Mr. Chairman, let me just say, I hear you. We can obviously work with you as you work through what you are doing, as you say. This, we believe, is part and parcel to a lot of the things we put forward. We understand that adding it at this moment adds to your challenge and we hope to help you as you work through getting a bill from here to there.

Chairman DODD. I appreciate that.

Senator Crapo asked that I include a statement he wanted for the record, that he wanted to put in for the Financial Services Roundtable, and I will ask consent that that be included in the record, as well.

Chairman DODD. We will have a continuation of this hearing on Thursday with others coming forward, and I appreciate, Mr. Wolin, your offer to continue to be helpful on this. But we are now going to begin moving fairly quickly.

Mr. WOLIN. Great.

Chairman DODD. The Committee will stand adjourned.

Mr. VOLCKER. Thank you very much.

Chairman DODD. Thank you.

[Whereupon, at 4:57 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional materials supplied for the record follow:]

### PREPARED STATEMENT OF SENATOR TIM JOHNSON

As we all know all too well, the financial crisis revealed that our financial services marketplace is desperately in need of reform. We also learned that some financial firms were participating in high risk activities, and that a number of “too-big-to fail” institutions were so interconnected that their high risk actions essentially set a series of traps in our financial services marketplace that became a serious threat to consumers, investors and the economy as a whole.

As Congress works on legislation to reform our financial system, this Committee has already identified two proposals that can help address this problem. First, better systemic risk regulation can help monitor risky activities by firms, and prevent and stop activities that could pose a threat to the economy as a whole. Second, Resolution Authority will provide a path forward if an institution fails without putting the taxpayer on the hook. These two steps are invaluable to decreasing risk in our nation’s marketplace.

In addition to these ongoing efforts, the Administration has proposed another idea to minimize economic threats to our system by prohibiting certain high-risk investment activities by banks and bank holding companies. I applaud the Chairman for holding two hearings on this proposal this week. I look forward to hearing more of the details from Chairman Volcker and Deputy Secretary Wolin today.

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### PREPARED STATEMENT OF SENATOR SHERROD BROWN

Thank you, Mr. Chairman, for holding this hearing on the Administration’s plan to curb risky investment activities by banks. I also want to welcome the witnesses and thank them for their participation.

Chairman Volcker made the point recently that that the ATM has been the biggest innovation in the financial services industry over the past 20 years. The leading provider of ATM technology, NCR Corporation, started in Dayton, Ohio.

I agree with Chairman Volcker that we should support the sorts of financial innovations that have value for working families.

Unfortunately, instead of helping working families save and invest, the largest financial institutions “innovated” in ways that fueled the financial crisis.

Despite the fact that these large, dangerously intertwined institutions recklessly underwrote exotic securities and gambled on toxic assets, they received a multibillion-dollar bailout from American taxpayers.

It may have been necessary to prevent a complete financial collapse, but that doesn’t make it any less noxious. Americans are disgusted that Wall Street can make or break our economy. So am I.

And while the big banks got help, some of the smaller banks have not been so lucky, particularly in Ohio.

National City Corp. was a vital part of the Cleveland community from 1845 until 2008. National City experienced severe difficulties caused by its involvement in the subprime market, but the Treasury Department denied its application for TARP funds. Instead, the government gave PNC Bank TARP money to purchase National City.

This unfortunate development cost an untold number of jobs in Ohio. In response to this case, I sent a letter to Treasury letting them know of my concern about the TARP program being used to fund bank consolidation, rather than helping to rescue small, ailing banks.

Over 1 year later, it appears that my concerns were justified. Large banks are bigger than ever, and they are reaping great benefits from their expansion and consolidation.

A study by the Center for Economic and Policy Research found that the “too big to fail” banks that carry implicit government guarantees are able to borrow at a lower interest rate than other banks. According to their figures, this implicit “too big to fail” guarantee amounts to a government subsidy of \$34.1 billion a year to the 18 banks with more than \$100 billion in assets.

Consolidation is also hurting community banks, thrifts and credit unions. According to the Kansas City Fed, the top four banks raised fees related to deposits by an average of 8 percent in the second quarter last year. To compete with the big banks, smaller banks lowered their fees by an average of 12 percent during the same period. This is the classic story of the big guys running the smaller guys out of town . . . at the expense of free market competition.

These consolidations are not only undercutting community banks and their customers, but they are breeding the very environment that threw our financial system into chaos, creating a deep, deep recession.

We don't want to bail out another set of "too big to fail" banks. We don't want to see risk multiplied a thousand fold by mega banks that have trillions of dollars in assets.

We need regulatory reform because we need strict oversight of the major threats to our financial system posed by the size and activity of large, interconnected financial institutions. We need to tackle head-on the "too big to fail" problem. As you said in excellent your op-ed in Sunday's New York Times, Chairman Volcker, "We need to face up to needed structural changes, and place them into law."

Thank you, Mr. Chairman. I look forward to hearing the witnesses' testimony.

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**PREPARED STATEMENT OF PAUL A. VOLCKER**

CHAIRMAN, PRESIDENT'S ECONOMIC RECOVERY ADVISORY BOARD

FEBRUARY 2, 2010

Mr. Chairman, Members of the Banking Committee:

You have an important responsibility in considering and acting upon a range of issues relevant to needed reform of the financial system. That system, as you well know, broke down under pressure, posing unacceptable risks for an economy already in recession. I appreciate the opportunity today to discuss with you one key element in the reform effort that President Obama set out so forcibly a few days ago.

That proposal, if enacted, would restrict commercial banking organizations from certain proprietary and more speculative activities. In itself, that would be a significant measure to reduce risk. However, the first point I want to emphasize is that the proposed restrictions should be understood as a part of the broader effort for structural reform. It is particularly designed to help deal with the problem of "too big to fail" and the related moral hazard that looms so large as an aftermath of the emergency rescues of financial institutions, bank and non-bank, in the midst of crises.

I have attached to this statement a short essay of mine outlining that larger perspective.

The basic point is that there has been, and remains, a strong public interest in providing a "safety net"—in particular, deposit insurance and the provision of liquidity in emergencies—for commercial banks carrying out essential services. There is not, however, a similar rationale for public funds—taxpayer funds—protecting and supporting essentially proprietary and speculative activities. Hedge funds, private equity funds, and trading activities unrelated to customer needs and continuing banking relationships should stand on their own, without the subsidies implied by public support for depository institutions.

Those quintessential capital market activities have become part of the natural realm of investment banks. A number of the most prominent of those firms, each heavily engaged in trading and other proprietary activity, failed or were forced into publicly assisted mergers under the pressure of the crisis. It also became necessary to provide public support via the Federal Reserve, The Federal Deposit Insurance Corporation, or the Treasury to the largest remaining American investment banks, both of which assumed the cloak of a banking license to facilitate the assistance. The world's largest insurance company, caught up in a huge portfolio of credit default swaps quite apart from its basic business, was rescued only by the injection of many tens of billions of dollars of public loans and equity capital. Not so incidentally, the huge financial affiliate of one of our largest industrial companies was also extended the privilege of a banking license and granted large assistance contrary to long-standing public policy against combinations of banking and commerce.

What we plainly need are authority and methods to minimize the occurrence of those failures that threaten the basic fabric of financial markets. The first line of defense, along the lines of Administration proposals and the provisions in the Bill passed by the House last year, must be authority to regulate certain characteristics of systemically important non-bank financial institutions. The essential need is to guard against excessive leverage and to insist upon adequate capital and liquidity.

It is critically important that those institutions, its managers and its creditors, do not assume a public rescue will be forthcoming in time of pressure. To make that credible, there is a clear need for a new "resolution authority", an approach recommended by the Administration last year and included in the House bill. The concept is widely supported internationally. The idea is that, with procedural safeguards, a designated agency be provided authority to intervene and take control of a major financial institution on the brink of failure. The mandate is to arrange an orderly liquidation or merger. In other words, euthanasia not a rescue.

Apart from the very limited number of such “systemically significant” non-bank institutions, there are literally thousands of hedge funds, private equity funds, and other private financial institutions actively competing in the capital markets. They are typically financed with substantial equity provided by their partners or by other sophisticated investors. They are, and should be, free to trade, to innovate, to invest—and to fail. Managements, stockholders or partners would be at risk, able to profit handsomely or to fail entirely, as appropriate in a competitive free enterprise system.

Now, I want to deal as specifically as I can with questions that have arisen about the President’s recent proposal.

First, surely a strong international consensus on the proposed approach would be appropriate, particularly across those few nations hosting large multi-national banks and active financial markets. The needed consensus remains to be tested. However, judging from what we know and read about the attitude of a number of responsible officials and commentators, I believe there are substantial grounds to anticipate success as the approach is fully understood.

Second, the functional definition of hedge funds and private equity funds that commercial banks would be forbidden to own or sponsor is not difficult. As with any new regulatory approach, authority provided to the appropriate supervisory agency should be carefully specified. It also needs to be broad enough to encompass efforts sure to come to circumvent the intent of the law. We do not need or want a new breed of bank-based funds that in all but name would function as hedge or equity funds.

Similarly, every banker I speak with knows very well what “proprietary trading” means and implies. My understanding is that only a handful of large commercial banks—maybe four or five in the United States and perhaps a couple of dozen worldwide—are now engaged in this activity in volume. In the past, they have sometimes explicitly labeled a trading affiliate or division as “proprietary”, with the connotation that the activity is, or should be, insulated from customer relations.

Most of those institutions and many others are engaged in meeting customer needs to buy or sell securities: stocks or bonds, derivatives, various commodities or other investments. Those activities may involve taking temporary positions. In the process, there will be temptations to speculate by aggressive, highly remunerated traders.

Given strong legislative direction, bank supervisors should be able to appraise the nature of those trading activities and contain excesses. An analysis of volume relative to customer relationships and of the relative volatility of gains and losses would go a long way toward informing such judgments. For instance, patterns of exceptionally large gains and losses over a period of time in the “trading book” should raise an examiner’s eyebrows. Persisting over time, the result should be not just raised eyebrows but substantially raised capital requirements.

Third, I want to note the strong conflicts of interest inherent in the participation of commercial banking organizations in proprietary or private investment activity. That is especially evident for banks conducting substantial investment management activities, in which they are acting explicitly or implicitly in a fiduciary capacity. When the bank itself is a “customer”, *i.e.*, it is trading for its own account, it will almost inevitably find itself, consciously or inadvertently, acting at cross purposes to the interests of an unrelated commercial customer of a bank. “Inside” hedge funds and equity funds with outside partners may generate generous fees for the bank without the test of market pricing, and those same “inside” funds may be favored over outside competition in placing funds for clients. More generally, proprietary trading activity should not be able to profit from knowledge of customer trades.

I am not so naive as to think that all potential conflicts can or should be expunged from banking or other businesses. But neither am I so naive as to think that, even with the best efforts of boards and management, so-called Chinese Walls can remain impermeable against the pressures to seek maximum profit and personal remuneration.

In concluding, it may be useful to remind you of the wide range of potentially profitable services that are within the province of commercial banks.

- First of all, basic payments services, local, national and worldwide, ranging from the now ubiquitous automatic teller machines to highly sophisticated cash balance management;
- Safe and liquid depository facilities, including especially deposits contractually payable on demand;

- Credit for individuals, governments and businesses, large and small, including credit guarantees and originating and securitizing mortgages or other credits under appropriate conditions;
- Analogous to commercial lending, underwriting of corporate and government securities, with related market making;
- Brokerage accounts for individuals and businesses, including “prime brokerage” for independent hedge and equity funds;
- Investment management and investment advisory services, including “Funds of Funds” providing customers with access to independent hedge or equity funds;
- Trust and estate planning and Administration;
- Custody and safekeeping arrangements for securities and valuables.

Quite a list. More than enough, I submit to you, to provide the base for strong, competitive—and profitable—commercial banking organizations, able to stand on their own feet domestically and internationally in fair times and foul.

What we can do, what we should do, is recognize that curbing the proprietary interests of commercial banks is in the interest of fair and open competition as well as protecting the provision of essential financial services. Recurrent pressures, volatility and uncertainties are inherent in our market-oriented, profit-seeking financial system. By appropriately defining the business of commercial banks, and by providing for the complementary resolution authority to deal with an impending failure of very large capital market institutions, we can go a long way toward promoting the combination of competition, innovation, and underlying stability that we seek.

#### HOW TO REFORM OUR FINANCIAL SYSTEM

*The New York Times*, January 30, 2010

By Paul Volcker, Op-Ed Contributor

President Obama 10 days ago set out one important element in the needed structural reform of the financial system. No one can reasonably contest the need for such reform, in the United States and in other countries as well. We have after all a system that broke down in the most serious crisis in 75 years. The cost has been enormous in terms of unemployment and lost production. The repercussions have been international.

Aggressive action by governments and central banks—really unprecedented in both magnitude and scope—has been necessary to revive and maintain market functions. Some of that support has continued to this day. Here in the United States as elsewhere, some of the largest and proudest financial institutions—including both investment and commercial banks—have been rescued or merged with the help of massive official funds. Those actions were taken out of well-justified concern that their outright failure would irreparably impair market functioning and further damage the real economy already in recession.

Now the economy is recovering, if at a still modest pace. Funds are flowing more readily in financial markets, but still far from normally. Discussion is underway here and abroad about specific reforms, many of which have been set out by the United States administration: appropriate capital and liquidity requirements for banks; better official supervision on the one hand and on the other improved risk management and board oversight for private institutions; a review of accounting approaches toward financial institutions; and others.

As President Obama has emphasized, some central structural issues have not yet been satisfactorily addressed.

A large concern is the residue of moral hazard from the extensive and successful efforts of central banks and governments to rescue large failing and potentially failing financial institutions. The long-established “safety net” undergirding the stability of commercial banks—deposit insurance and lender of last resort facilities—has been both reinforced and extended in a series of ad hoc decisions to support investment banks, mortgage providers and the world’s largest insurance company. In the process, managements, creditors and to some extent stockholders of these non-banks have been protected.

The phrase “too big to fail” has entered into our everyday vocabulary. It carries the implication that really large, complex and highly interconnected financial institutions can count on public support at critical times. The sense of public outrage over seemingly unfair treatment is palpable. Beyond the emotion, the result is to provide those institutions with a competitive advantage in their financing, in their size and in their ability to take and absorb risks.

As things stand, the consequence will be to enhance incentives to risk-taking and leverage, with the implication of an even more fragile financial system. We need to find more effective fail-safe arrangements.

In approaching that challenge, we need to recognize that the basic operations of commercial banks are integral to a well-functioning private financial system. It is those institutions, after all, that manage and protect the basic payments systems upon which we all depend. More broadly, they provide the essential intermediating function of matching the need for safe and readily available depositories for liquid funds with the need for reliable sources of credit for businesses, individuals and governments.

Combining those essential functions unavoidably entails risk, sometimes substantial risk. That is why Adam Smith more than 200 years ago advocated keeping banks small. Then an individual failure would not be so destructive for the economy. That approach does not really seem feasible in today's world, not given the size of businesses, the substantial investment required in technology and the national and international reach required.

Instead, governments have long provided commercial banks with the public "safety net." The implied moral hazard has been balanced by close regulation and supervision. Improved capital requirements and leverage restrictions are now also under consideration in international forums as a key element of reform.

The further proposal set out by the president recently to limit the proprietary activities of banks approaches the problem from a complementary direction. The point of departure is that adding further layers of risk to the inherent risks of essential commercial bank functions doesn't make sense, not when those risks arise from more speculative activities far better suited for other areas of the financial markets.

The specific points at issue are ownership or sponsorship of hedge funds and private equity funds, and proprietary trading—that is, placing bank capital at risk in the search of speculative profit rather than in response to customer needs. Those activities are actively engaged in by only a handful of American mega-commercial banks, perhaps four or five. Only 25 or 30 may be significant internationally.

Apart from the risks inherent in these activities, they also present virtually insolvable conflicts of interest with customer relationships, conflicts that simply cannot be escaped by an elaboration of so-called Chinese walls between different divisions of an institution. The further point is that the three activities at issue—which in themselves are legitimate and useful parts of our capital markets—are in no way dependent on commercial banks' ownership. These days there are literally thousands of independent hedge funds and equity funds of widely varying size perfectly capable of maintaining innovative competitive markets. Individually, such independent capital market institutions, typically financed privately, are heavily dependent like other businesses upon commercial bank services, including in their case prime brokerage. Commercial bank ownership only tilts a "level playing field" without clear value added.

Very few of those capital market institutions, both because of their typically more limited size and more stable sources of finance, could present a credible claim to be "too big" or "too interconnected" to fail. In fact, sizable numbers of such institutions fail or voluntarily cease business in troubled times with no adverse consequences for the viability of markets.

What we do need is protection against the outliers. There are a limited number of investment banks (or perhaps insurance companies or other firms) the failure of which would be so disturbing as to raise concern about a broader market disruption. In such cases, authority by a relevant supervisory agency to limit their capital and leverage would be important, as the president has proposed.

To meet the possibility that failure of such institutions may nonetheless threaten the system, the reform proposals of the Obama administration and other governments point to the need for a new "resolution authority." Specifically, the appropriately designated agency should be authorized to intervene in the event that a systemically critical capital market institution is on the brink of failure. The agency would assume control for the sole purpose of arranging an orderly liquidation or merger. Limited funds would be made available to maintain continuity of operations while preparing for the demise of the organization.

To help facilitate that process, the concept of a "living will" has been set forth by a number of governments. Stockholders and management would not be protected. Creditors would be at risk, and would suffer to the extent that the ultimate liquidation value of the firm would fall short of its debts.

To put it simply, in no sense would these capital market institutions be deemed "too big to fail." What they would be free to do is to innovate, to trade, to speculate, to manage private pools of capital—and as ordinary businesses in a capitalist economy, to fail.

I do not deal here with other key issues of structural reform. Surely, effective arrangements for clearing and settlement and other restrictions in the now enormous market for derivatives should be agreed to as part of the present reform program. So should the need for a designated agency—preferably the Federal Reserve—charged with reviewing and appraising market developments, identifying sources of weakness and recommending action to deal with the emerging problems. Those and other matters are part of the Administration's program and now under international consideration.

In this country, I believe regulation of large insurance companies operating over many states needs to be reviewed. We also face a large challenge in rebuilding an efficient, competitive private mortgage market, an area in which commercial bank participation is needed. Those are matters for another day.

What is essential now is that we work with other nations hosting large financial markets to reach a broad consensus on an outline for the needed structural reforms, certainly including those that the president has recently set out. My clear sense is that relevant international and foreign authorities are prepared to engage in that effort. In the process, significant points of operational detail will need to be resolved, including clarifying the range of trading activity appropriate for commercial banks in support of customer relationships.

I am well aware that there are interested parties that long to return to "business as usual," even while retaining the comfort of remaining within the confines of the official safety net. They will argue that they themselves and intelligent regulators and supervisors, armed with recent experience, can maintain the needed surveillance, foresee the dangers and manage the risks.

In contrast, I tell you that is no substitute for structural change, the point the president himself has set out so strongly.

I've been there—as regulator, as central banker, as commercial bank official and director—for almost 60 years. I have observed how memories dim. Individuals change. Institutional and political pressures to "lay off" tough regulation will remain—most notably in the fair weather that inevitably precedes the storm.

The implication is clear. We need to face up to needed structural changes, and place them into law. To do less will simply mean ultimate failure—failure to accept responsibility for learning from the lessons of the past and anticipating the needs of the future.

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**PREPARED STATEMENT OF NEAL S. WOLIN**  
DEPUTY SECRETARY, DEPARTMENT OF THE TREASURY

FEBRUARY 2, 2010

Chairman Dodd, Ranking Member Shelby, thank you for the opportunity to testify before your Committee today about financial reform—and in particular about the Administration's recent proposals to prohibit certain risky financial activities at banks and bank holding companies and to prevent excessive concentration in the financial sector.

The recent proposals complement the much broader set of reforms proposed by the Administration in June, passed by the House in December, and currently under consideration by this Committee. We have worked closely with you and with your staffs over the past year, and we look forward to working with you to incorporate these additional proposals into comprehensive legislation.

Sixteen months from the height of the worst financial crisis in generations, no one should doubt the urgent need for financial reform. Our regulatory system is outdated and ineffective, and the weaknesses that contributed to the crisis still persist. Through a series of extraordinary actions over the last year and a half, we have made significant progress in stabilizing the financial system and putting our economy back on the path to growth. But the progress of recovery does not diminish the urgency of the task at hand. Indeed, our financial system will not be truly stable, and our recovery will not be complete, until we establish clear new rules of the road for the financial sector.

The goals of financial reform are simple: to make the markets for consumers and investors fair and efficient; to lay the foundation for a safer, more stable financial system, less prone to panic and crisis; to safeguard American taxpayers from bearing risks that ought to be borne by shareholders and creditors; and to end, once and for all, the dangerous perception any financial institution is "Too Big to Fail."

The ingredients of financial reform are clear:

All large and interconnected financial firms, regardless of their legal form, must be subject to strong, consolidated supervision at the Federal level. The idea that in-

vestment banks like Bear Stearns or Lehman Brothers or other major financial firms could escape consolidated Federal supervision should be considered unthinkable from now on.

The days when being large and substantially interconnected could be cost-free—let alone carry implicit subsidies—should be over. The largest, most interconnected firms should face significantly higher capital and liquidity requirements. Those requirements should be set at levels that compel the major financial firms to pay for the additional costs that they impose on the financial system, and give such firms positive incentives to reduce their size, risk profile, and interconnectedness.

The core infrastructure of the financial markets must be strengthened. Critical payment, clearing, and settlement systems, as well as the derivatives and securitization markets, must be subject to thorough, consistent regulation to improve transparency, and to reduce bilateral counterparty credit risk among our major financial firms. We should never again face a situation—so devastating in the case of AIG—where a virtually unregulated major player can impose risks on the entire system.

The government must have robust authority to unwind a failing major financial firm in an orderly manner—imposing losses on shareholders, managers, and creditors, but protecting the broader system and ensuring that taxpayers are not forced to pay the bill.

The government must have appropriately constrained tools to provide liquidity to healthy parts of the financial sector in a crisis, in order to make the system safe for failure.

And we must have a strong, accountable consumer financial protection agency to set and enforce clear rules of the road for providers of financial services—to ensure that customers have the information they need to make fully informed financial decisions.

Throughout the financial reform process, the Administration has worked with Congress on reforms that will provide positive incentives for firms to shrink and to reduce their risk and to give regulators greater authorities to force such outcomes. The Administration's White Paper, released last June, emphasized the need to give regulators extensive authority to limit risky, destabilizing activities by financial firms. We worked closely with Chairman Frank and subcommittee Chairman Kanjorski in the House Financial Services Committee to give regulators explicit authority to require a firm to cease activities or divest businesses that could threaten the safety of the firm or the stability of the financial system.

In addition, through tougher supervision, higher capital and liquidity requirements, the requirement that large firms develop and maintain rapid resolution plans—also known as “living wills”—and the financial recovery fee which the President proposed at the beginning of January, we have sought indirectly to constrain the growth of large, complex financial firms.

As we have continued our ongoing dialog, within the Administration and with outside advisors such as the Chairman of the President's Economic Recovery Advisory Board, former Federal Reserve Chairman Paul Volcker, whose counsel has been of tremendous value, we have come to the conclusion that further steps are needed: that rather than merely authorize regulators to take action, we should impose mandatory limits on proprietary trading by banks and bank holding companies, and related restrictions on owning or sponsoring hedge funds or private equity funds, as well as on the concentration of liabilities in the financial system. These two additional reforms represent a natural—and important—extension of the reforms already proposed.

Commercial banks enjoy a Federal Government safety net in the form of access to Federal deposit insurance, the Federal Reserve discount window, and Federal Reserve payment systems. These protections, in place for generations, are justified by the critical role the banking system plays in serving the credit, payment and investment needs of consumers and businesses.

To prevent the expansion of that safety net and to protect taxpayers from risk of loss, commercial banking firms have long been subject to statutory activity restrictions, and they remain subject to a comprehensive set of activity restrictions today. Activity restrictions are a hallowed part of this country's bank regulatory tradition, and our new scope proposals represent a natural evolution in this framework.

The activities targeted by our proposal tend to be volatile and high risk. Major firms saw their hedge funds and proprietary trading operations suffer large losses in the financial crisis. Some of these firms “bailed out” their troubled hedge funds, depleting the firm's capital at precisely the moment it was needed most. The complexity of owning such entities has also made it more difficult for the market, investors, and regulators to understand risks in major financial firms, and for their man-

agers to mitigate such risks. Exposing the taxpayer to potential risks from these activities is ill-advised.

Moreover, proprietary trading, by definition, is not done for the benefit of customers or clients. Rather, it is conducted solely for the benefit of the bank itself. It is therefore difficult to justify an arrangement in which the Federal safety net redounds to the benefit of such activities.

For all these reasons, we have concluded that proprietary trading, and the ownership or sponsorship of hedge funds and private equity funds, should be separated, to the fullest extent practicable, from the business of banking—and from the safety net that benefits the business of banking.

While some details concerning the implementation of these proposals will appropriately be worked out through the regulatory process following enactment, it may be helpful if I take a moment to clarify the Administration's intentions on a few particularly salient issues.

First, with respect to the application of the proposed scope limits: all banking firms would be covered. This means any FDIC-insured depository institution, as well as any firm that controls an FDIC-insured depository institution. In addition, the proposal would apply to the U.S. operations of foreign banking organizations that have a U.S. branch or agency and are therefore treated under current U.S. law as bank holding companies. The prohibition also would generally apply to the foreign operations of U.S.-based banking firms.

This proposal forces firms to choose between owning an insured depository institution and engaging in proprietary trading, hedge fund, or private equity activities. But—and this is very important to emphasize—it does not allow any major firm to escape strict government oversight. Under our regulatory reform proposals, all major financial firms, whether or not they own a depository institution, must be subject to robust consolidated supervision and regulation—including strong capital and liquidity requirements—by a fully accountable and fully empowered Federal regulator.

Second, with respect to the types of activity that will be prohibited: this proposal will prohibit investments of a banking firm's capital in trading operations that are unrelated to client business. For instance, a firm will not be allowed to establish or maintain a separate trading desk, capitalized with the firm's own resources, and organized to speculate on the price of oil and gas or equity securities. Nor will a firm be allowed to evade this restriction by simply rolling such a separate proprietary trading desk into the firm's general market making operations.

The proposal would not disrupt the core functions and activities of a banking firm: banking firms will be allowed to lend, to make markets for customers in financial assets, to provide financial advice to clients, and to conduct traditional asset management businesses, other than ownership or sponsorship of hedge funds and private equity funds. They will be allowed to hedge risks in connection with client-driven transactions. They will be allowed to establish and manage portfolios of short-term, high-quality assets to meet their liquidity risk management needs. Traditional merger and acquisition advisory, strategic advisory, and securities underwriting, and brokerage businesses will not be affected.

In sum, the proposed limitations are not meant to disrupt a banking firm's ability to serve its clients and customers effectively. They are meant, instead, to prevent a banking firm from putting its clients, customers and the taxpayers at risk by conducting risky activities solely for its own enrichment.

Let me now turn to the second of the President's recent proposals: the limit on the relative size of the largest financial firms.

Since 1994, the United States has had a 10 percent concentration limit on bank deposits. The cap was designed to constrain future concentration in banking. Under this concentration limit, firms generally cannot engage in certain inter-state banking acquisitions if the acquisition would put them over the deposit cap.

This deposit cap has helped constrain the growth in concentration among U.S. banking firms over the intervening years, and it has served the country well. But its narrow focus on deposit liabilities has limited its usefulness. Today, the largest U.S. financial firms generally fund themselves at significant scale with non-deposit liabilities. Moreover, the constraint on deposits has provided the largest U.S. financial firms with a perverse incentive to fund themselves through more volatile forms of wholesale funding. Given the increasing reliance on non-bank financial intermediaries and non-deposit funding sources in the U.S. financial system, it is important to supplement the deposit cap with a broader restriction on the size of the largest firms in the financial sector.

This new financial sector size limit should not require existing firms to divest operations. But it should serve as a constraint on future excessive consolidation among our major financial firms.

The size limit should not impede the organic growth of financial firms—after all, we do not want to limit the growth of successful businesses. But it should constrain the capacity of our very largest financial firms to grow by acquisition.

The new limit should supplement, not replace, the existing deposit cap. And it should at a minimum cover all firms that control one or more insured depository institutions, as well as all other major financial firms that are so large and interconnected that they will be brought into the system of consolidated, comprehensive supervision contemplated by our reforms.

An updated size limit for financial firms will have a beneficial effect on the overall health of the financial system. Limiting the relative size of any single financial firm will reduce the adverse effects from the failure of any single firm. These proposals should strengthen our financial system's resiliency. It is true today that the financial systems of most other G7 countries are far more concentrated than ours. It is also true today that major financial firms in many other economies generally operate with fewer restrictions on their activities than do U.S. banking firms. These are strengths of our economy—strengths that we intend to preserve.

Limits on the scale and scope of U.S. banking firms have not materially impaired the capacity of U.S. firms to compete in global financial markets against larger, foreign universal banks, nor have these variations stopped the United States from being the leading financial market in the world. The proposals I have discussed today preserve the core business of banking and serving clients, and preserve the ability of even our largest firms to grow organically. Therefore we are confident that we should not impact the competitiveness of our financial firms and our financial system.

Before closing, I would like to again emphasize the importance of putting these new proposals in the broader context of financial reform. The proposals outlined above do not represent an "alternative" approach to reform. Rather, they are meant to supplement and complement the set of comprehensive reforms put forward by the Administration last summer and passed by the House of Representatives before the holidays.

Added to the core elements of effective financial reform previously proposed, the activity restrictions and concentration cap that are the focus of today's hearing will play an important role in making the system safer and more stable. But like each of the other core elements of financial reform, the scale and scope proposals are not designed to stand alone.

Members of this Committee have the opportunity—by passing a comprehensive financial reform bill—to help build a safer, more stable financial system. It is an opportunity that may not come again. We look forward to working with you to bring financial reform across the finish line—and to do all that we can to ensure that the American people are never again forced to suffer the consequences of a preventable financial catastrophe.

Thank you.

**RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING  
FROM PAUL A. VOLCKER**

**Q.1.** The government safety net for financial firms is larger than just deposit insurance. In particular, the Fed has made its lending available to all kinds of firms, including those that are not banks. Should firms that have access to any forms of Fed money be subject to these same limits on risk taking?

**A.1.** Yes.

**Q.2.** Under this proposal, would banks be allowed to continue their derivatives dealer business?

**A.2.** Yes, as long as they are originating these products on behalf of their customers, and are not trading them for their own account.

**Q.3.** Chairman Volker, in your New York Times piece you state that there are some investment banks and insurance companies that are too big to fail. What do you propose we do about them?

**A.3.** To be clear, I think I said that some of those firms present systemic risk, but in my view no firm is too big to fail. Their financial statements, business practices, and interconnectedness would be continuously reviewed by a "Systemic Overseer", as well they would be subject to reasonable capital, leverage and liquidity requirements. These firms would also be operating under the auspices of a new resolution authority for non-banks.

**Q.4.a.** Chairman Volker, would you allow Goldman Sachs and Morgan Stanley, which became bank holding companies in order to get greater access to Fed money, to drop their bank charters so they could keep trading on their own account?

**A.4.a.** Yes, and then they would be operating outside the Federal safety net.

**Q.4.b.** If yes, how would that resolve any of the systemic risks posed by those firms?

**A.4.b.** They would be subject to the supervision outlined in my answer to Question 3. In the event of their failure, they would be liquidated or merged under a new resolution authority for nonbanks.

**Q.5.** Under this proposal, would banks be allowed to lend to hedge funds or private equity firms?

**A.5.** Yes, as these funds would be considered customers of the banks.

**Q.6.** What measurement do you propose we use to limit the size of financial institutions in the future?

**A.6.** I think the deposit and liability cap being contemplated by the Treasury is a reasonable means of limiting the size of financial institutions. I have not yet seen the percentage limit being proposed by Treasury, however I understand a new cap will be high enough so as not to require any existing firm to shrink. Size, though, is not the sole criteria for measuring the systemic risk of an institution. It is important to have an Overseer that is looking at the complexity and diversification of the institution's holdings, its interconnectedness with other institutions and markets, and other risk measures.

**Q.7.** If we put in place size limitations or trading limitations, who is going to be able to step in and buy other large firms that are in danger of failing? For example, what would happen to a transaction like the Bank of America–Merrill Lynch merger?

**A.7.** Again, I defer to Treasury with respect to the size criteria to be proposed. In the future, I hope that we will have a stable of strong financial institutions capable of executing such a transaction should a large bank or non-bank fail. If we do not have institutions that are capable *and willing* to acquire or merge with a competitor in trouble, then the failing firm will be liquidated under the auspices of the new resolution authority for non-banks.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR BENNETT  
FROM NEAL S. WOLIN**

**Q.1.** As you know, many major banks and bank-holding companies in the United States offer prime brokerage services to their large institutional clients. In fact, prime brokerage is significant source of revenue for some of these banking entities. SEC Regulation SHO requires that, prior to executing a short sale, a prime broker need only “locate” shares on behalf of a client.

It is possible to “over-lend” shares without ever firmly locating the shares. Under existing regulations prime brokers are compensated for lending the customers’ shares for uses that are often contrary to their customers’ investment strategies.

What is the Administration doing to bring full disclosure and accountability to this process and do you think that the government should at least require the major banks and bank-holding companies that offer prime brokerage services to obtain affirmative, knowing consent of the customer for the lending of their shares at the time the consumer signs the brokerage agreement?

**A.1.** Did not respond by publication deadline.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING  
FROM NEAL S. WOLIN**

**Q.1.** In his testimony, Chairman Volker makes it clear that banks would continue to be allowed to package mortgages or other assets into securities and sell them off. That was an activity that was at the center of the credit bubble and the current crisis. Why should banks be allowed to continue that behavior?

**A.1.** Did not respond by publication deadline.

**Q.2.** The government safety net for financial firms is larger than just deposit insurance. In particular, the Fed has made its lending available to all kinds of firms, including those that are not banks. Should firms that have access to any forms of Fed money be subject to these same limits on risk taking?

**A.2.** Did not respond by publication deadline.

**Q.3.** Under this proposal, would banks be allowed to continue their derivatives dealer business?

**A.3.** Did not respond by publication deadline.

**Q.4.a.** Would you allow Goldman Sachs and Morgan Stanley, which became bank holding companies in order to get greater access to Fed money, to drop their bank charters so they could keep trading on their own account?

**A.4.a.** Did not respond by publication deadline.

**Q.4.b.** If yes, how would that resolve any of the systemic risks posed by those firms?

**A.4.b.** Did not respond by publication deadline.

**Q.5.** Under this proposal, would banks be allowed to lend to hedge funds or private equity firms?

**A.5.** Did not respond by publication deadline.

**Q.6.** Secretary Wolin, what measurement do you propose we use to limit the size of financial institutions in the future?

**A.6.** Did not respond by publication deadline.

**Q.7.** If we put in place size limitations or trading limitations, who is going to be able to step in and buy other large firms that are in danger of failing? For example, what would happen to a transaction like the Bank of America–Merrill Lynch merger?

**A.7.** Did not respond by publication deadline.

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**RESPONSE TO WRITTEN QUESTIONS OF SENATOR VITTER  
FROM NEAL S. WOLIN**

**Q.1.** How would you define proprietary trading?

**A.1.** Did not respond by publication deadline.

**Q.2.** Will the restrictions on proprietary trading and hedge fund ownership apply to all bank holding companies—including Goldman Sachs and Morgan Stanley—or only to deposit taking institutions?

**A.2.** Did not respond by publication deadline.

**Q.3.** Do you think the failure of Lehman Brothers would have been less painful if these rules had been in place? If you do, please explain how.

**A.3.** Did not respond by publication deadline.

**Q.4.** Do you think it would have been easier to allow AIG or Bear Stearns to fail if these rules had been in place? If you do, please explain why.

**A.4.** Did not respond by publication deadline.

**Q.5.** It would also be instructive to hear from you how the largest bank failures in U.S. history. How would the Volker rule have impacted Washington Mutual and IndyMac? Please be specific to each institution and each aspect of the proposed limit in size and scope.

**A.5.** Did not respond by publication deadline.

**Q.6.** Do you think that it would be easier in the future to allow any large, interconnected non-bank financial institution to fail if these rules are in place? If so, why?

**A.6.** Did not respond by publication deadline.

**Q.7.** How does limiting the size and scope of an institution prevent banks from making too many risky home loans?

**A.7.** Did not respond by publication deadline.

**Q.8.** In your testimony you correctly say, "Since 1994, the United States has had a 10 percent concentration limit on bank deposits. The cap was designed to constrain future concentration in banking. Under this concentration limit, firms generally cannot engage in certain inter-state banking acquisitions if the acquisition would put them over the deposit cap. This deposit cap has helped constrain the growth in concentration among U.S. banking firms over the intervening years, and it has served the country well."

Yet, you also say that the new size limit "should not require existing firms to divest operations."

Why should we not consider this newly proposed rule as protecting the chosen few enormous institutions that are currently too big to fail?

**A.8.** Did not respond by publication deadline.

**Q.9.** Banking regulators have waived long standing rules in order to allow certain companies to hold more than 10 percent of the nation's deposits despite a rule barring such a practice. Do you support a continued waiver, or should the regulators enforce the statutory depository caps?

**A.9.** Did not respond by publication deadline.

**Q.10.** A sad truth of the sweeping government interventions and bailouts last year is that it has made the problem of "too big to fail" worse because it has increased the spread between the average cost of funds for smaller banks and the cost of funds for larger "too big to fail" institutions. A study done by the FDIC shows that it has become even more profitable.

Do you believe that there are currently any financial companies that are too big and should be broken up?

**A.10.** Did not respond by publication deadline.

## ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

GONE FISHING: E. GERALD CORRIGAN AND THE ERA OF  
MANAGED MARKETS*The Herbert Gold Society, February 1, 1993*

By Christopher Whalen

Financial markets and many foreign governments were taken by surprise in early January when New York Federal Reserve Bank President **E. Gerald Corrigan** suddenly resigned. In the unusual press conference called to announce his decision, Corrigan, who officially leaves the New York Fed in August, made a point of denying that there was any "hidden agenda" in his departure from more than 20 years of public service.

Yet a good part of his career was not public and, indeed, was deliberately concealed, along with much of the logic behind many far-reaching decisions. Whether you agreed with him or not, Corrigan was responsible for making difficult choices during a period of increasing instability in the U.S. financial system and the global economy. During the Volcker era, as the Fed Chairman received the headlines, his intimate friend and latter day fishing buddy Corrigan did "all the heavy lifting behind the scenes," one insider recalls.

Because of his important, albeit behind-the-scenes role, Corrigan's sudden decision to step down is doubly wrapped in mystery. A Democrat politically associated with Establishment Liberal personalities, Corrigan under President Bill Clinton seemed likely to be at the head of the list of prospects to succeed Chairman Greenspan. Thus he sheds the limelight under circumstances and in such a way as will only intensify speculation about numerous pending issues, including his role in the Salomon Brothers scandal, the Iraq-Banco Nazionale del Lavoro affair, the BCCI collapse and widely rumored misconduct in the LDC debt market, to cite only part of a longer list of professional and personal concerns.

One nationally known journalist who has closely followed Corrigan's career says that "there is more to come" on both the Salomon and BNL fronts, and also predicts that several lesser Fed officials close to Corrigan also may be implicated. In fact, it appears that the New York Fed chief decided to resign in the face of several ongoing congressional and grand jury investigations that when completed might, perhaps, embarrass the publicity shy central bank and compel Chairman **Alan Greenspan** and the board of directors of the New York Reserve Bank to force him out.

The press statement from the Board of Governors in Washington, for example, stated that Corrigan had only just made his decision to resign, but why then the lengthy, 8-month period between the resignation and his departure? In fact, the search committee to find his replacement had begun its work days, perhaps weeks earlier. Even as Corrigan met the press, a personal emissary sent by Corrigan was completing a week-long swing through Europe to inform central bankers privately of the impending retirement, a final courtesy from the man who at first carried messages and later the weight of decisions during over 20 years surveying world financial markets.

Many political observers lament the loss of the Fed's most senior crisis manager, yet there is in fact considerable relief inside much of the Federal Reserve System at Corrigan's departure. "Break out the champagne," declared one former colleague. "Stalin is dead." The unflattering nickname refers to Corrigan's often abrasive, dictatorial management style.

But another 20-plus year Fed veteran, though no less critical of Corrigan's methods, worries that there is no financial official of real international stature at the central bank for the first time since **Paul Volcker** left New York to become Fed Chairman in 1979. "Aside from the rather aloof Greenspan," he frets, "there's no one in Washington or among the regional Reserve Bank presidents who is able to pick up the telephone and know which bankers to call in the event of a crisis. Greenspan knows everyone, but he is no banker."

Who will replace Gerry Corrigan? Candidates range from Fed Vice Chairman **David Mullins**, an Arkansas native, to economists and bankers from around the country. Yet to appreciate the scale of the task to select his replacement, it is first necessary to review Corrigan's long career. He probably will be best remembered in his last incarnations as both head of the Cooke bank supervisory committee and the chief U.S. financial liaison to the shaky government of **Boris Yeltsin** in Moscow, where he and the equally hard-drinking Russian leader often stayed up all night devising schemes to stave off a debt default. The Russian effort is perhaps most interesting to students of the Fed because of the combination of luck and divine providence that brought the New York Fed chief and the Russian leader together in the

first place and also because it illustrates many aspects of a two-decade long career that has been largely obscured from public view. But now the age of Corrigan is revealed, indirectly, in the vacuum his departure leaves at the top of the American financial system.

### **The Russian Business**

Early in the summer of 1991, Treasury Secretary **Nicholas Brady**, Fed Chairman Greenspan, Corrigan, and several lesser western functionaries traveled to Russia to meet with then-Soviet President **Mikhail Gorbachev**. The Brady-led economic SWAT team went to Moscow to hear the besieged Soviet leader ask for an assessment of the economic reforms that would be required for eventual International Monetary Fund membership (and the release of billions of dollars in new loans from the IMF a year later).

One evening during the visit, as Brady and Greenspan went off to dine with Gorbachev, an aide to Corrigan, who was not invited along for dinner, suggested that it would not be a bad idea to meet “discreetly” with Yeltsin. The meeting with the Russian leader was quietly arranged. Yeltsin, it should be remembered, had just completed a disastrous tour of the United States, where he was ignored by the Bush Administration, which saw him as a dangerous, often drunken irresponsible on the fringe of Soviet politics.

“Yeltsin deeply appreciated the courtesy of Corrigan’s visit,” according to one senior Fed official familiar with the details of the trip. About a month later, when the attempted military coup against Gorbachev thrust Yeltsin to the forefront, the Russian President did not forget his new-found dining companion and billiard partner, Gerald Corrigan. In November 1991, the New York Fed chief began a series of “technical assistance” trips, which usually included time for trips to the country and visits to such places as Stalin’s country house or *dacha*. He made many of his Russian trips in the company of a female Fed official that one peer described as the central bank’s answer to **James Baker’s** Margaret Tutwiller.

In January 1992, Corrigan hosted a dinner for 200 bankers and other close friends in Yeltsin’s honor at the New York Fed’s beautiful Italian-revival building at 33 Liberty Street in lower Manhattan, in the shadow of Chase Manhattan Bank and a stone’s throw from the House of Morgan. The two now-intimate friends reportedly danced and tossed back shots of vodka till the wee hours of the morning in the bank’s magnificent dining room.

Through 1991, as the once stalwart communist Yeltsin became deeply committed to “free market reform,” Corrigan began to advise Russia’s leader on economic matters. This role was formalized in February 1992, after the fact, when the Fed’s Board of Governors in Washington effectively appointed Corrigan “czar” to oversee American technical assistance to Moscow. Corrigan assembled a team of high-level financial experts from the New York financial community and led them to Russia at Yeltsin’s request, to study and recommend further financial reforms.

In May 1992, this team became part of a formal network called the “Russia-U.S. Forum,” of which Corrigan is co-chair and which includes such establishment fixtures as **David Rockefeller** and **Cyrus Vance** as directors. Significantly, Vance is a two-term member of the board of directors of the New York Fed and part of the search committee to find a replacement for Corrigan.

Thus the New York Fed chief, who was already the senior U.S. bank regulator, also assumed the role of financial liaison to the Yeltsin regime. Together with Corrigan’s long-time mentor, former Fed Chairman Volcker, who ironically acted as adviser to the Russian government after years of steering the world through the international debt crisis, Corrigan has been perhaps the most influential Western financial expert on the scene in Russia, particularly after James Baker moved to the White House in August 1992 to direct the abortive Bush reelection effort.

Yet were helping Russia move toward a market-based economy really Washington’s first priority, the fate that brought Yeltsin and Corrigan together would have to be seen as one of those crazy events in history when the wrong person was in the right place at the wrong time. “The oddest thing that is going on right now is that Gerry Corrigan is taking to Moscow a bunch of people from the big money center banks to tell them how to run a banking system,” financial author **Martin Mayer** noted during a seminar on banking at Ohio State University last summer. “The Russians don’t need that kind of help.”

Perhaps it is just a coincidence, but Corrigan’s resignation comes as Mayer is about to publish a new book later this year on the Salomon Brothers scandal that reveals the New York Fed’s central role in the debacle. Yet Corrigan’s willingness to tolerate Salomon’s market shenanigans is not surprising. By his own admission, Corrigan has never entirely or even partially trusted in free markets, and the Fed’s conduct in the Salomon affair was an illustration of this viewpoint put into practice.

The New York Fed knew that something was afoot in the government bond market but turned a blind eye to Salomon's machinations rather than risk the "stability" of the sales of Treasury paper.

Corrigan is a classic interventionist who sees the seemingly random workings of a truly free market as dangerously unpredictable. The intellectual author and sponsor of such uniquely modernist financial terms such as "too big to fail," which refers to the unwritten government policy to bail out the depositors of big banks, and "systemic risk," which refers to the potential for market disruption arising from inter-bank claims when a major financial institutions fails, Corrigan's career at the Fed was devoted to thwarting the extreme variations of the marketplace in order to "manage" various financial and political crises, a role that he learned and gradually inherited from former Chairman Volcker.

At a July 1, 1991 conference on restructuring financial markets, Corrigan said that relying entirely on market forces actually posed a risk to the world financial system. "There is a tendency to think that market forces must be good," he opined, and said also that the "challenge" for regulators will be how to "balance free market forces" with the "dictates of stability in the financial structure." And as Salomon and a host of other examples illustrate, Corrigan worked very hard to ensure that stability, regardless of the secondary impact on markets or the long-term cost.

A career of almost day-to-day crisis control stretched back to the Hunt Brothers silver debacle in 1980, but especially to the collapse of Drysdale Government Securities in 1982, the Mexican debt crisis (1982–1990) and the October 1987 market crash. Russia was Corrigan's greatest and last test, yet despite claims of fostering private sector activity in Russia or stability in domestic financial markets, in fact his first and most important priority over two decades of service was consistently bureaucratic: to help heavily indebted countries and their creditor banks navigate a financial minefield that was neither of his making nor within his power to remove. Like Volcker before him, Gerald Corrigan cleaned up the messes left behind by the big banks and politicians in Washington, and tried to keep a bad situation from getting any worse.

#### **Volcker's Apprentice**

Corrigan's unlikely rise to the top of the American financial system started in 1976 when as corporate secretary of the N.Y. Fed he was befriended by then-President Volcker. At the time, other senior officers of the New York Reserve Bank still were a bit stand-offish toward Volcker because of policy disagreements, most notably after America's abandonment of gold for international settlements at Camp David in August 1971, a move Volcker supported (he actually participated in the drafting of the plan). But Corrigan extended himself for the new president and quickly became his trusted adviser and friend, and the man doing the difficult jobs behind the scenes as Volcker attracted the limelight as the crisis manager.

When Volcker was appointed Fed Chairman late in the summer of 1979, Corrigan followed him to Washington as the chairman's aide and hands-on situation manager (although he remained on the New York Fed's payroll and was subsequently promoted). He was quickly thrown into the crisis control fray when Bunker and Herbert Hunt's attempt to manipulate the silver market blew up into a \$1.3 billion disaster the following year. Corrigan managed the unwinding of silver positions, providing the moral suasion necessary to convince reluctant banks to furnish credit to brokers who made bad loans to the Hunts to finance their silver purchases.

In 1982, when Drysdale Government Securities collapsed, Corrigan was again the man on the scene to do the cleanup job, working to avoid the worst effects of one of the ugliest financial debacles in the post war period. Drysdale was the first in a series of shocks that year which included the Mexican debt default and the collapse of Penn Square Bank.

Drysdale threatened not only the workings of the government securities market, but the stability of a major money center bank, Chase Manhattan, which saw its stock plummet when rumors began to fly as to the magnitude of losses. Corrigan fashioned a combination of Fed loans of cash and collateral, and other expedients, to make the crisis slowly disappear, even as Volcker again received public credit for meeting the crisis.

It was about this time that Corrigan, who had never shown any inclination toward outdoor sports (although he is an avid pro-football fan), discovered a love for fly fishing, a favorite pastime of Volcker. He joined a select group of cronies such as current New York Fed foreign adviser and former Morgan Stanley partner **Ed Yeo** and then-IMF managing director **Jacques de Larosiere**, who would go on long fishing trips.

We may never know what was discussed while this select group let their lines dangle into the water, but fishing no doubt took up far less than most of the time.

Later in 1982 Volcker, who was by then supervising the unfolding Penn Square situation, pushed for Corrigan to take the open presidency of the Minneapolis Fed. (Volcker later admitted wanting to keep the badly insolvent Penn Square open for fear of wider market effects, but the FDIC closed down the now infamous Oklahoma bank, paying out only on insured deposits.)

Significantly, as Volcker promoted Corrigan's career within the Fed, he took extraordinary measures to prevent the nomination or appointment of respected economists and free market advocates like **W. Lee Hoskins** and **Jerry L. Jordan** to head other Reserve Banks (both Hoskins and later Jordan were appointed to the Cleveland Reserve Bank's presidency after Volcker's departure in 1987). Hoskins in particular was the antithesis of Volcker, an unrepentant exponent of conservative, sound money theory who advocated making zero inflation a national goal. He left the Cleveland Fed last year to become president of the solid Huntington Bank in Columbus (which interestingly was among the last institutions to approve new bank loans for Chrysler in 1992).

Hoskins and other free market exponents believe that ill-managed banks should be allowed to fail and that Federal deposit insurance hurts rather than protects the financial system by allowing banks to take excessive risks that are, in effect, subsidized by the American taxpayer. But this free market perspective, which represented mainstream American economic thought before the New Deal, is at odds with the Volcker-Corrigan view of avoiding "systemic risk" via public sops for large banks and other, more generalized types of government intervention in the "private" marketplace.

Volcker moved to protect his bureaucratic flank in 1984 when he nominated Corrigan as a replacement for **Anthony Solomon** as president at the New York Fed, an event that required almost as much lobbying as was latter needed to block the appointment of Hoskins to head the St. Louis Fed in 1986. The cigar chomping Fed chairman got on a plane to call a rare Sunday meeting of the Reserve Bank's board, where he reportedly pounded the table and warned of being outnumbered by Reagan-era free market-zealots. The St. Louis Fed's board caved in to Volcker's demands and Hoskins was passed-over, although he would be appointed President of the Cleveland Fed in late 1987, after Volcker no longer was Federal Reserve Board Chairman.

Significantly, Corrigan's impending selection in 1984 caused several more conservative line officers and research officials to flee the New York Reserve Bank. **Roger Kubarych**, one of the deputy heads of research in New York and a widely respected economist on Wall Street (he's Henry Kaufman's chief economist), actually resigned the day Corrigan's appointment was formally announced, fulfilling an earlier vow not to serve under Volcker's apprentice that symbolized earlier internal Fed disputes.

### The Neverending Crisis

From the first day he took over as head of the New York Fed in 1985, Corrigan's chief priority was "managing" the LDC debt crisis and in particular its devastating effects on the New York money center banks. Even in the late 1980s, when most scholars and government officials admitted that loans to countries like Brazil, Argentina and Mexico would have to be written off, as J.P. Morgan did in 1989, Corrigan continued to push for new lending to indebted countries in an effort to bolster the fiction that loans made earlier could still be carried at par or book value, 100 cents on the dollar. Even today, when some analysts declare the debt crisis to be over, the secondary market bid prices for LDC debt range from 65 cents for Mexico to 45 cents for Argentina and 25 cents for Brazil.

"Anything approaching a 'forced' write down of even a part of the debt—no matter how well dressed up—seems to me to run the risks of inevitably and fatally crushing the prospects for fresh money financing that is so central to growth prospects of the troubled LDCs and to the ultimate restoration of their credit standing," Corrigan wrote in the New York Fed quarterly review in 1988. "A debt strategy that cannot hold out the hope of renewed debtor access to market sources of external finance is no strategy at all."

And of course, in the case of Mexico, debt relief has been followed by massive new lending and short-term investment, albeit to finance a growing external trade imbalance (\$15 billion in deficit during the first 9 months of 1992 alone) that is strikingly similar to the import surge which preceded the 1982 debt default. Likewise bankrupt Russia, which is supposedly cutoff from new Western credit, has received almost \$18 billion in new western loans over the past 12 months—loans guaranteed by the taxpayers of the G-7 countries.

But in addition to pressing for new loans to LDC countries, Corrigan worked hard at home to manage the debt crisis, bending accounting rules, delaying and even in-

tervening in the closing of bank examinations, resisting regulatory initiatives such as market value accounting for banks' investment securities portfolios and initially promoting the growth of the interbank loans, swaps and other designer "derivative" assets now traded for short-term profit in the growing secondary market. In particular, Corrigan played a leading role in affording regulatory forbearance to a number of large banks with fatal levels of exposure to heavily indebted countries in Latin America. But no member of the New York Clearing House has received more special treatment than Citibank, the lead bank of the \$216 billion total asset Citicorp organization.

When former Citicorp chairman **Walter Wriston** said that sovereign nations don't go bankrupt, this in response to questions about his bank's extensive financial risk exposure because of lending in Latin America, his supreme confidence in the eventual outcome of the LDC debt crisis was credible because he and other financiers knew that senior Fed officials like Volcker and Corrigan would do their best to blunt the impact of bad LDC loans on the balance sheets and income statements of major banking institutions. In 1989, for example, as Wriston's successor, **John Reed**, was in Buenos Aires negotiating a debt-for-equity swap to reduce his bank's credit exposure in Argentina, Corrigan pressured bank examiners in New York to keep open the bank's examination for 14 months. This unprecedented intervention in a regularly scheduled audit contradicted the Fed's own policy statements in 1987 to the effect that large banks would be examined *every 6 months*, with a full-scope examination every year.

Corrigan's decision (he and other Fed officials refuse to discuss regulatory issues as a matter of standing policy) probably was made in order to avoid charges against earnings by forcing the bank to post higher reserves against its illiquid Third World loan portfolio, an action that would later be taken anyway as Argentina slid further down the slope of inflation and political chaos.

Yet in a recent internal memo, Corrigan declared the debt crisis "resolved," even as LDC debt continues to grow, both in nominally and in real, inflation-adjusted terms. Public sector debt has fallen in Mexico, for example, accumulation of new private loans and short-term investment has driven total foreign debt over \$120 billion, notwithstanding the abortive Brady Plan, while real wages in Mexico continue to deteriorate. This is about \$30 billion more than Mexico's total debt level following the Brady Plan debt exchange in 1989.

It is significant to note that while Corrigan and other officials pushed the Baker plan after 1985 (essentially a new money lending program) to help "buy time" for commercial banks, as Volcker did before him, there remain literally thousands of unsecured commercial creditors of Mexico, Brazil and other LDCs who have little hope of ever seeing even the meager benefits such as World Bank guarantees on interest payments accorded to commercial banks under the Brady scheme. Indeed, because of its debt reduction aspects there remains doubt as to whether Corrigan even fully endorsed the abortive Brady Plan.

### **Systemic Risk & Fiat Money**

As vice chairman of the Federal Open Market Committee, a position by law held by the New York Fed chief, Corrigan consistently supported the forces pushing for easy money in recent years in order to reflate the domestic economy and eastern real estate markets, and thereby to bolster the sagging balance sheets of insolvent money center behemoths.

In fairness, it must be said that Mr. Corrigan, for the most part, was merely following Chairman Greenspan's lead on those monetary policy votes. Since becoming a Reserve Bank president in 1982, he never dissented in an FOMC vote against the chairman's position under either Volcker or Greenspan. Yet as Bill Clinton seems destined to discover, embracing inflationism today in order to accommodate Federal deficits, and bail out badly managed commercial banks and real estate developers, has its price tomorrow in terms of maintaining long-term price and financial market stability.

Several of the nation's largest commercial banks, which are headquartered in Corrigan's second Fed district, are or until recently have been by any rational, market-oriented measure insolvent and should have been closed or merged away years ago. Concern about the threat to the financial markets of "systemic risk" is used to keep big banks alive, and also as a broad justification for all types of market intervention.

The reasoning behind "systemic risk" goes something like this: If Russia defaults on its debts, large banks (mostly in Europe) will fail, causing other banks and companies to lose money and also fail. Therefore, new money must keep flowing to countries like Russia, Mexico, Brazil and Argentina so that they may remain current on private debts to commercial lenders, essentially the old-style pyramid or Ponzi

scheme on an international scale, funded by taxpayers in America, Europe and Japan via inflation and public sector debt.

When Corrigan gave a speech earlier this year warning about the risks inherent in derivative, off-balance sheet instruments such as interest rate swaps, many market participants wondered aloud if the New York Fed chief really understands the market he once promoted but now so fears. "Off-balance sheet activities have a role, but they must be managed and controlled carefully," he told a mystified audience at the New York State Bankers Association in February. "And they must be understood by top management as well as traders and rocket scientists."

Swap market mavens were right to wonder about Corrigan's grasp of derivative securities, but they might better ask whether Corrigan appreciates the connection between embracing easy money and inflation to bail out the big banks, and the expansion of derivative markets. In fact, the growth of the swaps market in particular and financial innovation generally, is fueled by paper dollars created by monetary expansion, credit growth that Corrigan has long and repeatedly advocated within the FOMC's closed councils.

From \$2 trillion in 1990, the derivatives market grew to \$3.8 trillion at the end of last year (Citicorp is one quarter of the total swaps market) and may double again before the end of 1994. And yet in basic, purely financial terms, there is no difference between an interest rate swap with a counterparty incapable of understanding the risk, a loan to Brazil, and the commercial real estate loans that fueled the Olympia & York disaster; all are simply vehicles for marketing credit in a market awash in paper, legal tender greenbacks created by an increasingly politicized Federal Reserve Board.

In addition to the exponential growth in markets such as interest rate swaps, another side effect of expansionary monetary policy has been an increase in market volatility generally. When the great mountain of dollars created by the Fed during the previous decade suddenly moved out of U.S. equities on Black Monday, October 19, 1987, the New York Fed under Corrigan reportedly urged private banks to purchase stock index futures to stabilize cash prices on the New York Stock Exchange. Corrigan bluntly told commercial banks to lend to brokers in order to help prop the market up, and dealers were even allowed to borrow collateral directly from the Fed in order to alleviate a short-squeeze. Orchestrating such a financial rescue is still intervention in the free market, albeit of an indirect nature.

In October 1987, banks in Europe and Japan had refused to lend Treasury paper to counterparties in New York, many of whom had been taken short by customers and other dealers during the frenzied flight to quality that occurred, from stocks into AAA-rated U.S. Government debt. The Fed saved many dealers from grave losses by lending securities they could not otherwise obtain, but this seemingly legitimate response to a market upheaval still represents government inspired meddling in the workings of a supposedly private market. Traders who sell short a stock or bond that they cannot immediately buy back in the market at a lower price are no better than gamblers who have none to blame save themselves for such stupidity and should seek the counsel of a priest or bartender.

But in an illustration of the broadly corporativist evolution of Fed policy, as manifested in the government bond market, Corrigan sought broader powers to support the dealer community. In fact, in the wake of the bond market collateral squeeze in 1987 (and again during the "mini crash" in October 1989), the New York Fed chief pushed for and late last year obtained authority from Congress to lend directly to broker-dealers in "emergencies," thus allowing the central bank to provide direct liquidity support to the U.S. stock market the next time sellers badly outnumber buyers.

When it came time to explain the 1987 debacle to the Congress and the American people, Corrigan was more than willing to help the private citizen drafted to oversee the task, former New Jersey Senator Nicholas Brady, who after being appointed to the Presidential commission created to study the crash, became Treasury Secretary in 1988 when James Baker left the government to run the Bush election campaign.

Yet Corrigan assisted the work of Brady's hand-picked assistants, Harvard professor **Robert Glauber**, who later became under secretary of the Treasury for Finance, and David Mullins, who also joined Brady's Treasury and is now a Bush-appointee as Vice Chairman of the Fed Board of Governors. Mullins and Glauber worked on the Brady report in offices provided by the New York Fed and reportedly dined regularly with Corrigan, who offered them his informed view of how financial markets work.

When the Salomon scandal erupted in the Spring and Summer of 1991, Corrigan was again the key man on the scene to manage the fallout from a debacle that has still been only partially unveiled. Following 1986, when regulatory responsibility for the government bond market had been explicitly given to the SEC, the Fed, at

Corrigan's instruction, had largely curtailed its surveillance of the market for Treasury debt, particularly the informal "when-issued" market in Treasury paper before each auction.

And yet when the Salomon scandal broke open, it was apparent that the hands-on "management" of markets prescribed by Corrigan had failed to prevent one of the great financial scandals of the century. "Neither in Washington nor in New York did the Fed seem aware that the dangers of failure to supervise this market had grown exponentially in 1991," Mayer notes in an early draft of his upcoming book on the Salomon debacle. "Like the Federal Home Loan Bank Board in its pursuit of making the S&Ls look solvent in 1981-82, the Fed had adopted tunnel-vision policies to save the nation's banks. And just as excessive kindness to S&Ls in the early 1980s had drawn to the trough people who should not have been in the thrift business, Fed monetary policies in the early 1990s created a carnival in the government bond business."

The Salomon crisis was not the only bogie on the scope in 1991. During December 1990, the Federal Reserve Bank of New York, working in concert with several private institutions, fashioned a secret rescue package for Chase Manhattan Bank when markets refused to lend money to the troubled banking giant. While Chase officials vociferously deny that any bailout occurred, the pattern of discount window loans during the period and off-the-record statements by officials at the Fed and several private banks suggest very strongly that Corrigan's personal intervention prevented a major banking crisis at the end of 1990.

Rational observers would agree that the collapse of a major banking institution is not a desirable outcome, but the larger, more fundamental issue is whether any private bank, large or small, should be subject to the discipline of the marketplace. In the case of Citibank, Chase and numerous other smaller institutions, Corrigan, like Volcker before him, answered this question with a resounding "no." The corporatist tendencies of this extra-legal arrangement amounts to the privatization of profits and the socialization of losses.

#### **A Question Of Principles**

The real issue raised by Corrigan and his supporters within the Fed bureaucracy has been not what they believe, but the fact that they did not seem to have any basic core beliefs with which to guide regulatory actions and policy recommendations during years of difficult domestic and international crises. Other than seeking to avoid a market-based resolution to bank insolvencies and other random events in the marketplace, for example, there is no discernible logic to "too big to fail."

While this attitude may be useful to elected officials, appointed higher ups and the CEOs of large banks, it cannot help confusing an American public that still believes that concepts like free markets and the rule of law matter. There is not, for example, any explicit statutory authority supporting the doctrine of "too big to fail," nor has Congress given the Fed authority to support the market for government bonds or even private equity via surreptitious purchases of stock index futures, as was alleged in 1987 and on several occasions since.

In the case of the conflict between monetary accommodation for big money center banks and complaining about the explosive growth of derivative products, for example, or warning about banking capital levels while allowing regulatory forbearance and financial accommodation for brain dead money center institutions, Corrigan's positions are riven with logical inconsistencies and interventionist prescriptives that, as the Salomon scandal also illustrates, fail to address the underlying problems. But it may be unfair to place all or even part of the blame for this incongruity at his feet alone.

Since beginning his work under Volcker in 1976, Corrigan has met and at least temporarily resolved each foreign and domestic crisis with various types of short-term expedients designed to maintain financial and frequently political stability. The rarefied atmosphere of crisis management leaves small time for recourse to first principles. In this respect, Corrigan must be seen as a pathetic figure, an errand boy doing difficult jobs for politicians and servile Fed Chairmen in Washington who have been unwilling to take the hard decisions needed to truly end the multiple crises that affected the American-centered world financial system since the 1960s abroad and the 1970s at home.

By at once advocating new lending to LDCs while softening regulatory treatment for heavily exposed money center institutions, Corrigan was at the forefront of efforts to forestall the day of financial reckoning for the big banks, whether from Third World loans, domestic crises arising from real estate loans, or highly leveraged transactions. However, if Russia, Mexico or some other financial trouble spot boils over after next summer, Gerry Corrigan will have gone fishing. And he will

leave behind a very large pair of much-traveled boots that Alan Greenspan and the Clinton Administration quickly must fill.

THE VOLCKER RULE & AIG: HEDGE FUNDS AND PROP  
DESKS ARE NOT THE PROBLEM

JANUARY 25, 2010

By Christopher Whalen

There are certain basic things that the investor must realize today. In the first place, he must recognize the weakness of his individual position . . . [T]he growth of investors from the comparative few of a generation ago to the millions of the present day has made it a practical impossibility for the individual investor to know what is occurring in the affairs of the corporation in which he has an interest. He has been forced to relegate his rights to a controlling class whose interests are often not identical to his own. Even the bondholder who has superior rights finds in many cases that these rights have been taken away from him by some clause buried in a complicated indenture . . . The second fact that the investor must face is that the banker whom tradition has considered the guardian of the investors' interests is first and foremost a dealer in securities; and no matter how prominent the name, the investor must not forget that the banker, like every other merchant, is primarily interested in his own greatest profit.

—*False Security: The Betrayal of the American Investor*, Bernard J. Reis and John T. Flynn, Equinox Cooperative Press, NY (1937).

*This is an expanded version of a comment we posted last week on ZeroHedge.*

Watching the President announcing the proposal championed by former Fed Chairman Paul Volcker to forbid commercial banks from engaging in proprietary trading or growing market share beyond a certain size, we are reminded of the reaction by Washington a decade ago in response to the Enron and WorldCom accounting scandals, namely the Sarbanes-Oxley law. The final solution had nothing to do with the actual problem and everything to do with the strange political relationship between the national Congress, the central bank and the Wall Street dealer community. We call it the “Alliance of Convenience.”

The basic problems illustrated by the Enron/WorldCom scandals were old fashioned financial fraud and the equally old use of off-balance sheet vehicles to commit same. By responding with more stringent corporate governance requirements, the Congress was seen to be responsive—but without harming Wall Street's basic business model, which was described beautifully by Bernard J. Reis and John T. Flynn some eighty years ago in the book *False Security*.

A decade since the Enron-WorldCom scandals, we still have the same basic problems, namely the use of OBS vehicles and OTC structured securities and derivatives to commit securities fraud via deceptive instruments and poor or no disclosure. Author Martin Mayer teaches us that another name for OTC markets is “bucket shop,” thus the focus on prop trading today in the Volcker Rule seems entirely off target—and deliberately so. The Volcker Rule, at least as articulated so far, does not solve the problem nor is it intended to. And what is the problem?

Not a single major securities firm or bank failed due to prop trading during the past several years. Instead, it was the securities origination and sales process, that is, the customer side of the business of originating and selling securities that was the real source of systemic risk. The Volcker Rule conveniently ignores the securities sales and underwriting side of the business and instead talks about hedge funds and proprietary trading desks operated inside large dealer banks. But this is no surprise. Note that former SEC chairman Bill Donaldson was standing next to President Obama on the dais last week when the President unveiled his reform, along with Paul Volcker and Treasury Secretary Tim Geithner.

Donaldson is the latest, greatest guardian of Wall Street and was at the White House to reassure the major Sell Side firms that the Obama reforms would do no harm. But frankly Chairman Volcker poses little more threat to Wall Street's largest banks than does Donaldson. After all, Chairman Volcker made his reputation as an inflation fighter and not in bank supervision. Chairman Volcker was never known as a hawk on bank regulatory matters and, quite the contrary, was always attentive to the needs of the largest banks.

Volcker's protege, never forget, was E. Gerald Corrigan, former President of the Federal Reserve Bank of New York and the intellectual author of the “Too Big To Fail” (TBTF) doctrine for large banks and the related economist nonsense of “sys-

temic risk.” But Corrigan, who now hangs his hat at Goldman Sachs (GS), did not originate these ideas. Corrigan was never anything more than the wizard’s apprentice. As members of the Herbert Gold Society wrote in the 1993 paper “*Gone Fishing: E. Gerald Corrigan and the Era of Managed Markets*”:

Yet a good part of his career was not public and, indeed, was deliberately concealed, along with much of the logic behind many far-reaching decisions. Whether you agreed with him or not, Corrigan was responsible for making difficult choices during a period of increasing instability in the U.S. financial system and the global economy. During the Volcker era, as the Fed Chairman received the headlines, his intimate friend and latter day fishing buddy Corrigan did ‘all the heavy lifting behind the scenes,’ one insider recalls.

The lesson to take from the Volcker-Corrigan relationship is don’t look for any reform proposals out of Chairman Volcker that will truly inconvenience the large, TBTF dealer banks. The Fed, after all, has for several decades been the chief proponent of unregulated OTC markets and the notion that banks and investors could ever manage the risks from these opaque and unpredictable instruments. Again to quote from the “*Gone Fishing*” paper:

Corrigan is a classic interventionist who sees the seemingly random workings of a truly free market as dangerously unpredictable. The intellectual author and sponsor of such uniquely modernist financial terms such as ‘too big to fail,’ which refers to the unwritten government policy to bail out the depositors of big banks, and ‘systemic risk,’ which refers to the potential for market disruption arising from inter-bank claims when a major financial institution fails. Corrigan’s career at the Fed was devoted to thwarting the extreme variations of the marketplace in order to ‘manage’ various financial and political crises, a role that he learned and gradually inherited from former Chairman Volcker.

As Wall Street’s normally selfish behavior spun completely out of control, Volcker has become an advocate of reform, but only focused on those areas that do not threaten Wall Street’s core business, namely creating toxic waste in the form of OTC derivatives such as credit default swaps and unregistered, complex assets such as collateralized debt obligations, and stuffing same down the throats of institutional investors, smaller banks and insurance companies. Securities underwriting and sales is the one area that you will most certainly not hear President Obama or Bill Donaldson or Chairman Volcker or HFS Committee Chairman Barney Frank mention. You can torment prop traders and hedge funds, but please leave the syndicate and sales desks alone.

Readers of The IRA will recall a comment we published half a decade ago (“*Complex Structured Assets: Feds Propose New House Rules*,” May 24, 2004), wherein we described how the SEC and other regulators knew that a problem existed regarding the underwriting and sale of complex structured assets, but did almost nothing. The major Sell Side firms pushed back and forced regulators to retreat from their original intention of imposing retail standards such as suitability and know your customer on institutional underwriting and sales. Before Enron, don’t forget, there had been dozens of instances of OTC derivatives and structured assets causing losses to institutional investors, public pensions and corporations, but Washington’s political class and the various regulators did nothing.

Ultimately, the “*Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities*” was adopted, but as guidance only; and even then, the guidance was focused mostly on protecting the large dealers from reputational risk as and when they cause losses to one of their less than savvy clients. The proposal read in part:

The events associated with Enron Corp. demonstrate the potential for the abusive use of complex structured finance transactions, as well as the substantial legal and reputational risks that financial institutions face when they participate in complex structured finance transactions that are designed or used for improper purposes.

The need for focus on the securities underwriting and sales process is illustrated by American International Group (AIG), the latest poster child/victim for this round of rape and pillage by the large Sell Side dealer banks. Do you remember Procter & Gamble (PG)? How about Gibson Greetings? AIG, along with many, many other public and private Buy Side investors, was defrauded by the dealers who executed trades with the giant insurer. The FDIC and the Deposit Insurance Fund is another large, perhaps the largest, victim of the structured finance shell game, but Chair-

man Volcker and President Obama also are silent on this issue. Proprietary trading was not the problem with AIG nor the cause of the financial crisis, but instead the sales, origination and securities underwriting side of the Sell Side banking business.

The major OTC dealers, starting with Merrill Lynch, Citigroup (C), GS and Deutsche Bank (DB) were sucking AIG's blood for years, one reason why the latest "reform" proposal by Washington has nothing to do with either OTC derivatives, complex structured assets or OBS financial vehicles. And this is why, IOHO, the continuing inquiry into the AIG mess presents a terrible risk to Merrill, now owned by Bank of America (BCA), GS, C, DB and the other dealers—especially when you recall that the AIG insurance underwriting units were lending collateral to support some of the derivatives trades and were also writing naked credit default swaps with these same dealers.

Deliberately causing a loss to a regulated insurance underwriter is a felony in New York and most other states in the United States. Thus the necessity of the bailout—but that was only the obvious reason. Indeed, the dirty little secret that nobody dares to explore in the AIG mess is that the *Federal bailout* represents the complete failure of state-law regulation of the U.S. insurance industry. One of the great things about the Reis and Flynn book excerpted above is the description of the assorted types of complex structured assets that Wall Street was creating *in the 1920s*. Many of these fraudulent securities were created and sold by insurance and mortgage title companies. That is why after the Great Depression, insurers were strictly limited to operations in a given state and were prohibited from operating on a national basis and from any involvement in securities underwriting.

The arrival of AIG into the high-beta world of Wall Street finance in the 1990s represented a completion of the historical circle and also the evolution of AIG and other U.S. insurers far beyond the reach of state law regulation. Let us say that again. The bailout of AIG was not merely about the counterparty financial exposure of the large dealer banks, but was also about the political exposure of the insurance industry and the state insurance regulators, who literally missed the biggest act of financial fraud in U.S. history. But you won't hear Chairman Volcker or President Obama talking about Federal regulation of the insurance industry.

And AIG is hardly the only global insurer that is part of the problem in the insurance industry. In case you missed it, last week the Securities and Exchange Commission charged General Re for its involvement in separate schemes by AIG and Prudential Financial (PRU) to manipulate and falsify their reported financial results. General Re, a subsidiary of Berkshire Hathaway (BRK), is a holding company for *global* reinsurance and related operations.

As we wrote last year ("*AIG: Before Credit Default Swaps, There Was Reinsurance*," April 2, 2009), Warren Buffett's GenRe was actively involved in helping AIG to falsify its financial statements and thereby mislead investors using reinsurance, the functional equivalent of credit default swaps. Yet somehow the insurance industry has been almost untouched by official inquiries into the crisis. Notice that in settling the SEC action, General Re agreed to pay \$92.2 million *and dissolve a Dublin subsidiary* to resolve Federal charges relating to sham finite reinsurance contracts with AIG and PRU's former property/casualty division. Now why do you suppose a U.S. insurance entity would run a finite insurance scheme through an affiliate located in Dublin? Perhaps for the same reason that AIG located a thrift subsidiary in the EU, namely to escape disclosure and regulation.

If you accept that situations such as AIG and other cases where Buy Side investors (and, indirectly, the U.S. taxpayer) were defrauded through the use of OTC derivatives and/or structured assets as the archetype "problems" that require a public policy response, then the Volcker Rule does not address the problem. The basic issue that still has not been addressed by Congress and most Federal regulators (other than the FDIC with its proposed rule on bank securitizations) is how to fix the markets for OTC derivatives and structured finance vehicles that caused losses to AIG and other investors.

Neither prop trading nor the size of the largest banks are the causes of the financial crisis. Instead, opaque OTC markets, deliberately deceptive structured financial instruments and a general lack of disclosure are the real problems. Bring the closed, bilateral world of OTC markets into the sunlight of multilateral, public price discovery and require SEC registration for all securitizations, and you start down the path to a practical solution. But don't hold your breath waiting for President Obama or the Congress or former Fed chairmen to start that conversation.

PREPARED STATEMENT OF THE FINANCIAL SERVICES ROUNDTABLE  
FEBRUARY 2, 2010

The Financial Services Roundtable (“Roundtable”) respectfully offers this statement for the record on “Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies.”

The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer.

The Roundtable supports the goals of the Administration and of Congress in building a stronger economy, and rebuilding a regulatory framework that is modern, effective, and encourages economic growth. We are concerned, however, that recent proposals outlined by President Obama and Paul Volcker, Chairman of President’s Economic Recovery Advisory Board, are a step in the wrong direction. The proposed “Volcker rule” would prohibit U.S. banks and their non-bank affiliates from owning, investing in or sponsoring hedge funds, private equity funds and proprietary trading operations for their own profit, “unrelated to serving customers.” While limited in detail, the “Volcker rule” could be interpreted as limiting the growth of small businesses; curtailing the ability of financial institutions to manage risk; increasing the cost of capital for businesses; and putting U.S. financial institutions at a competitive disadvantage to their European and Asian counterparts.

For example, proprietary trading, most broadly, is where a financial services company is putting their own capital at risk. By current regulation, bank-holding companies cannot acquire more than 5 percent of the shares of a company. Securities firms that are affiliated with banks can exceed the 5 percent limit under their merchant banking authority. This permits them to acquire shares in on-going firms, but they cannot operate those firms, and cannot hold the investment for more than a certain period of time. Many additional rules apply to ensure safety across the board.

To be clear, excessive risk can, and should, be curtailed. We are committed to sound risk management practices that benefit the long-term, sustained health of our financial institutions and economy at-large.

The Roundtable is committed to protecting consumers from irresponsible loans, trades and excessive risks. We will continue to work with both Congress and the Administration to ensure that these goals are met.