Financial Reforms to End Government Bailouts as We Know Them

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The policy workshop and this resulting book have an ambitious intellectual and practical challenge: setting out ways and means for ending government bailouts as we know them.

I want to paraphrase George Shultz when I say the object is to make the world safe for failure—failure of even the largest or “systemically important” institutions. That is an ambitious goal, but I share George’s feeling that the bailout mentality has been reinforced and become pervasive after the unprecedented rescues that have taken place in the past year or more, not just in the United States but in the world. The result has been at great expense to the different fiscal positions of various governments and in terms of monetary
policy actions. A by-product has been an unfortunate loss of credibility for central banks.

I wonder in looking at this whole problem of the financial system whether there isn’t some correlation between the number of financial engineers and the number of damaging failures in the market.

In any case, we have a large problem, and I don’t think we’ve seen the last of it. While zero interest rates may be necessary at the moment, they lead to some dangerous possibilities in terms of breeding more speculative excesses.

Let me try to deal with the particular issues of financial reform related to “too big to fail” and moral hazard. I was reminded in rereading a bit of The Wealth of Nations that Adam Smith had an answer to some of these problems. He worried about failures of banks—he thought they were overly inclined to involve themselves in speculative activities. The only good remedy he could think of was to keep them small. I’m not sure that what was possible in Scotland in 1776 is possible in the United States or other advanced financial systems today. I think we probably have to look for other answers, but if in the process we can keep the biggest banks somewhat smaller, that would help.

Let me try to clear up some definitions as you think about this problem. We talk about failure; we’ve had one clear failure in this period: Lehman Brothers. The stockholders lost everything. And while it remains to be seen how much the creditors lost, they certainly were affected. That was a failure situation without bailout. I think it’s fair to say it had some repercussions.

Then we had a number of institutions here and abroad: Bear Stearns, Countrywide, Wachovia, Washington Mutual,
Merrill Lynch—I’d include Fannie and Freddie on this list—that also failed in that they could no longer stand alone. As they merged, creditors were saved (though stockholders were wounded). They were too big to fail in terms of current attitudes but were not necessarily bailed out. It depends on what you mean by “bailed out,” since those institutions no longer exist or won’t exist over time. They are examples where assistance was needed to smooth a merger or to smooth liquidation, but they weren’t permitted to continue.

Next we have a whole list of other troubled institutions that received large official assistance going beyond usual liquidity support by the Federal Reserve and/or the Treasury. They’re still independent and operational; while some may be limping, they’re still there. In most cases management is still in place, and some are doing quite magnificently in terms of compensation. That, it seems to me, fills every definition of a true bailout.

What about systemic interdependence? It’s a fuzzy concept. Part of it means that the failure of some institutions, because they are so interconnected in obligations—in particular, to creditors and in terms of liabilities or assets—that their failure will cascade through the system and give rise to a wide-scale breakdown of the financial system. That was thought to be the case of AIG and, earlier, Bear Stearns.

But beyond the kind of mechanical spreading of breakdowns and failures there may be an even more important psychological point: if the creditors or the stockholders hurt in a failing institution, you may have incipient panic among other institutions that otherwise would be able to stand on their own. The psychological panic—a classic run on banks—gives rise to a problem for the whole system. This seems to me one of the
most difficult areas to deal with. We can talk about being tough on institutions or letting them fail, but as was the case in the fall of 2008, the officials were obviously concerned about the psychological effects of inducing runs on, or a sense of panic in, other institutions.

After that background, let me give a little picture of how I would like to see this situation approached. There are a lot of areas in which there is substantial consensus, at least in concept (some of that broad agreement will break down in practice) as to how to protect the financial institutions, the system, and individual institutions within the system from the kind of systemic breakdown to which I refer. It begins, I think, with risk management in the major institutions themselves. Obviously they did not do as well as they should have. Whether their incentives were correct or not is a large question. And I think there will be pressure—there should be pressure—on those institutions to improve risk management.

In the regulatory area, capital standards get a lot of attention. I think that’s appropriate. I believe there’s a limit on how far capital can be increased while keeping institutions economically viable, but there’s certainly room for a more effective approach in this area. There have to be some limits on leverage in important institutions. We have had accounting problems. We’ve had the problem of off–balance sheet assets and liabilities—with more liabilities than assets, I’m afraid. Those kinds of issues ought to be taken care of by a more effective regulatory system. And while they may not require legislation in and of themselves, there are important questions of who does the regulation that obviously are the provenance of legislation and congressional policy.
We have the whole difficult area of compensation practices to deal with. I must confess that I admired a Wall Street Journal article in which Henry Mintzberg, a professor at McGill business school up in Canada (maybe the location says something), was arguing that the whole idea of stock compensation and stock options is mistaken. He argues that people ought to be paid in cash salaries, depending on a judgment as to their effectiveness over time. It’s a short summary of a very persuasive article, and though I don’t know how many people will be persuaded, compensation practices are important.

Finally, clearance and settlement practices in the derivatives area are of some consequence. The matter has caught everybody’s attention after the AIG fiasco with credit default swaps, and the administration and others have been working hard to get settlement practices that can better assure outstanding derivatives can be taken care of in a way that will not unsettle the whole system and lead to systemic problems.

That’s all fine against a background that there is a limit to how far we can go on regulation without losing the essence of active, flexible, innovative private markets. Private markets are important, and we’ve got to keep them flowing. So how do we solve that dilemma between regulation, appropriate capital standards (appropriate meaning higher than they’ve been), derivatives, and reasonable compensation practices, while keeping the strength of private markets? Let me take this opportunity to put my own approach on the table, and it starts with a kind of philosophical differentiation in my mind.

On one side we have banks, and it strikes me that banks are still the center of the financial system. They have lost
ground, relatively, in direct supplies of credit to other instruments over the past two or three decades, but they are still the heart of the system: they run the payments system for individuals, businesses, and governments; they run it domestically and internationally. No economy can survive without an effective payments system, and that’s the job of banks. They are key providers of credit to businesses, particularly to small and medium-sized businesses, and certainly to individuals. They are the conduit for monetary policy and have a special role in the economy for that reason.

Commercial banks and commercial banking systems in the United States and elsewhere are characterized today by a fairly high degree of concentration. Given the importance of the function and the size of the institution, there obviously are systemic implications. As opposed to capital markets, continuing relationships are an inherent part of the commercial banking business: they serve consumers, they serve businesses, they serve government, and they serve nonprofit institutions.

Capital markets, which trade in securities, among other things, have a significant function in providing a certain degree of liquidity and access of large-scale buyers and sellers of securities to markets that can develop and serve their needs, but they’re basically impersonal markets. They don’t depend on continuing customer relationships in the same way that commercial banks do. They are important but impersonal. They are less interconnected than commercial banks by the nature of their responsibilities and therefore by and large less systemically important, although large capital market institutions obviously create a problem and have systemic implications.
My bottom line is that I would treat banks differently from nonbanks. What do I mean by that? Commercial banks have a long history—decades; centuries—in which they’ve been protected and supervised one way or another by governments and central banks. The protection is in recognition of the importance of stability and continuity in those areas of the market. I think that should continue in its traditional way of deposit insurance, Federal Reserve liquidity support, and close (in relative terms) regulation. There can be improvements in each of those areas, which come under the subject matter I mentioned earlier to provide protection against a general breakdown of the market.

Capital markets, in contrast, have not traditionally enjoyed the same protection, and, of course, they haven’t had the same degree of regulation. I’m fine with going light on the regulation and not providing the protection, but I think this is where we really want to make the point that these institutions are not going to be too big to fail, that they will be permitted to fail, that in case of difficulty they will either fail or be merged. They should not, in my opinion, have the option of receiving official support and continuing as independent institutions.

Once one says that, the question arises, how do you deal with such institutions if they’re big and failure is likely to have broader implications? This is where the question of a resolution authority comes into play. There’s a general consensus, as I see it, on the need for this in the United States and elsewhere. This should be coordinated internationally—a regulatory authority or some official body that will take over a big, presumably systemically important institution on the brink of failure and will become
responsible for an orderly liquidation or a merger of that institution. In other words, it would provide a kind of funeral parlor, not an emergency ward, not a recovery ward in a hospital, but something that will be dealt with in a way that does not provide any rescue, any relief for the stockholder or indeed for the bondholder, if it turns out in the end that the institution is so weak in terms of assets that it cannot meet the obligations of its bondholders as well. There may be some need for some transitional official assistance to smooth the path toward liquidation or to smooth the merger, but it should not be assistance to keep the institution alive in my view.

That would be different for the commercial banks, where the possibility of keeping significant institutions alive, presumably with the loss of stockholder funds, might be reasonable. On the other hand, I would reduce the opportunities for the large commercial banking institutions needing assistance by saying they should not get involved heavily in essentially capital market activity.

What do I mean by that? The easy examples are they shouldn’t be doing hedge funds, they shouldn’t be doing equity funds, and they shouldn’t be doing proprietary trading either in securities or in commodities. Those are functions that are logical for the unprotected capital market but do not seem to me reasonable for the protected commercial banking sector. And of course, if they’re prohibited from those activities, they will also become smaller institutions than they now are. It won’t make them small—only smaller in the case of some of the very large institutions, which I think does go in the right direction.
Among other things, such activities inherently involve important conflicts of interest in those institutions. They make them more difficult to manage. They obviously have diverted management attention and understanding in the past, and I think we ought to make an effort to simplify the management of the protected sector of the economy.

So that is the broad view that I see: a distinction between commercial banks and capital markets. Just to be clear, I don’t go back to the pre-Glass-Steagall distinction. Glass-Steagall essentially prohibited underwriting of corporate securities. I think underwriting is now close enough to securitization and to normal lending to large companies that I would permit banks to do underwriting. But I would draw the line on proprietary trading; I think a distinction can be made between proprietary trading and customer-related trading, which would be a much smaller volume and that that distinction ought to be enforced.

So I think that gives you some kind of basis, at least going some distance toward “ending government bailouts as we know them.” I have conceded the possibility of something that might be called a bailout for a commercial bank in exceptional circumstances, but it would be a different kind of bailout than we have had, so I think it fits within the mandate of this group to end the bailouts as we know them.

Let’s let commercial banks be commercial banks. Let’s let capital market institutions do their thing in capital markets, essentially unprotected. Let’s not have any more protection of the commercial banks than is absolutely necessary but recognize that regulation and some protection in that area is likely to continue to be needed.