

# EUROFI INTERNATIONAL FORUM

GÖTEBORG Sept. 29 – Oct. 1<sup>st</sup> 2009

**INTERVIEW OF PAUL VOLCKER**  
**Chairman of President Obama's**  
**Economic Recovery Advisory Board**  
Interview recorded in Thomson Reuters  
Offices in New York on September 24 2009

**Jacques de Larosière, Co-President of Eurofi :** This is an important moment, with the G20 in Pittsburgh, the European Commission having now disclosed the legal documents that are going to be submitted to the Council of Ministers and that are based on the document that we wrote a few months ago. Things are moving.

We would be extremely interested if you could share with us your views on the major objectives and challenges of a global reform of the financial regulatory and supervisory system.

**Jacques de Larosière**



REUTERS/Benoît Tessier

**Paul Volcker :** You are dealing with a topic obviously very close to my heart. I was testifying only this morning in front of the American Congress just about this matter and of course the general objective which I am sure we all share is how we can have an effective financial system that can serve the needs of businesses and individuals around the world.

**Paul Volcker**



REUTERS/Lucas Jackson

We have to take into account of course that our system is international now.

It has become very complex and we have had this breakdown of the system last year that disrupted the real economies, disrupted the American economy and disrupted the economy in Europe and elsewhere in a very serious way.

So we've got to try to redesign this system in such a way that the possibility of breakdown is minimized and hopefully eliminated. And it is a difficult task.

The focus here is on I think the most difficult part of it. That is how to deal with the expectation of market participants that they will be rescued when there is a fear of failure.

There's been a lot of rescuing going on and at a high expenditure in my country and in European countries and the so called moral hazard problem looms large and that is something that we need to really draw attention to.

**Jacques de Larosière** : We really need to reform the system in order to do exactly what you've just said that is to eliminate that moral hazard.

And the thing I'd like to say is that this really has to be done in a global fashion.

We can't have the addition of regional systems, the US system, EU systems, and others. We really have to have a common rule book and have a mechanism that will ensure that this is being observed by the major players.

That is one of the challenges that I think is very important. It is to have consistency in the supervisory system.

**Paul Volcker** : You've been very concerned about that international aspect which is crucial.

We can't have a system in which there are big advantages and disadvantages that will undercut the effort to get the degree of consistency that we need in order to deal with moral hazard and a lot of other questions.

That's been a struggle even in Europe and will be a bigger struggle internationally but we have to find the points that are really crucial and insist upon some international coordination.

**Thomson Reuters** : What are your expectations regarding the outcome of the process of reform engaged in the US and how does that dovetail with the process engaged in the EU?

**Paul Volcker**: In the broader sense this is the question of how we deal with this moral hazard problem. Who's going to be protected if anybody?

Are some institutions entitled to protection and are some not? You want to minimize that. That is a broad underlying question.

But then you come to very specific questions. If you are going to have capital standards, you need them to be reasonably consistent.

That's been recognized for decades. If you are going to have liquidity standards they are going to have to be reasonably consistent also.

I think we need to be consistent among the institutions that we want to protect and the ones that we should not want to protect. Let's assume that banks will be protected.

That's been common ground among all developed countries for centuries, if not centuries certainly decades and a century.

But the activities that banks can engage in is an important issue. It's certainly going to be an important issue in the US. This is another area where we need consistency.

**Thomson Reuters** : You speak about protecting banks. I've heard you say that autos or AIG did not need to be protected, so where do you draw the line? What are the credentials for being protected or not protected?

**Paul Volcker**: I didn't say autos and AIG should not have been protected. [It was] under the conditions that existed last fall. We want to have a system where that does not become necessary in the future. That is precisely my urgency.

**Eurofi**: The importance of detecting systemic risk early is recognized on both sides of the Atlantic. What are your views on the differences between the US concept of the "Financial Oversight Council" and the European concept of the "Systemic Risk Council"?

**Paul Volcker**: In the US, in the EU, but also in Japan, in China and anywhere else you want to look, there will be a framework of protection for banks, a so called safety net. I think we start with common ground there.

What banks should be able to do is an issue.



What we do with institutions outside of banks that may be important is an interesting and difficult question also.

I would like to think that there aren't that many of those institutions right around the world that are entitled to protection, that are big enough, dangerous enough so to speak, interrelated enough, so that they provide a risk to the financial system that means they should be subject to the kind of support, examination or supervision that the banking system is.

I'm not sure how much of a consensus there is on that issue but I do think that the number of institutions that we need to have determined surveillance of is limited.

But I think there are some and if we have some, we want to ward off the need for a rescue by imposing capital or leverage requirements if they reach a certain stage, which is going to be partly a matter of size but not entirely a matter of size.\*

**Eurofi: In what way is size a good criterion to define systemically important institutions?**

**Paul Volcker** : We've had a little discussion about that in the United States and given the complexity of markets it is very difficult to set out very precise criteria.

And once you do that you have a problem in defining who's inside the circle and who's outside the circle.

**Eurofi : Do you think that some rules related to the size of financial institutions should be defined ex ante for example through a new Glass Steagal act?**

**Paul Volcker**: I believe we should not try to identify with great precision which non banking firms are matters of great concern. I think you can have a general approach but in the end you have to leave that to judgment.

Bigness is important but you can get some of these [institutions] in real trouble, even if they are not so big, if they are involved in certain types of transactions.

When you get to the banks themselves I do think that we ought to limit the activities that banks can undertake in the interest of protecting their stability and protecting their ability to serve their fundamental purposes.

Banks are the backbone of any financial system.

They run the payment system, you need a place to put your money in where it is safe and liquid, they can lend you money, they can lend businesses money, they can underwrite securities, they can give you investment advice, they might even manage your investments.

That's already a big menu. I don't think they have any real business in doing a lot of those speculative proprietary trading [activities].

I don't want to see them running hedge funds, I don't want to see them running private equity funds and that will be an interesting question for banks in my view, for European banks as well as for American banks.

**Eurofi : How do you explain the difference in approach between the US and Europe, with Europe more in favour of a risk based approach as defined in Basel II?**

**Paul Volcker** : I think we end up with a system that pays attention to varying risks of the bank. That's been the tendency in recent years.

That's what the Basel people have been concerned with. I think there is also a role for a simple leverage ratio that is kind of a fail safe mechanism with which you begin to worry about any of these institutions if capital relative to assets gets too extended.



REUTERS

**Eurofi: How to achieve not only a common set of rules but also a common and effective implementation process at the global level? Would Jacques de Larosière's idea of an international treaty with clear obligations and sanctions make sense?**

**Paul Volcker:** Jacques is a very imaginative forward thinker. In this particular area he's a little ahead of me to say the least.

I think that the idea of having a formal treaty and very formal agreements on a large variety of issues is probably beyond us. I think that it is very important to get agreements with some degree of technical specificity and we have done it in the area of capital which is a very important and sensitive area right now.

I certainly think we ought to seek commonality and I think we will get it in the context of the Financial Stability Board that the Chiefs of State have expressed a lot of interest in and given some prestige to.

I think that for liquidity problems and certain banking practices you can get, I hope, a high degree of consistency but I don't think it will be incorporated into a treaty and I don't think we'll have a supervisory body that can have real authority to say the French have to do this because they aren't doing it right and the Americans are doing everything perfectly and everyone ought to follow or visa versa.

**Eurofi: From a market perspective do you see a risk of regulatory arbitrage if we can't get to common rules?**

**Paul Volcker :** This is an important aspect. We have regulatory arbitrage in all countries and certainly in the US between regulatory agencies and between the former financial institutions.

I'll give you a big example in the US, I don't think it's so important in Europe. That is money market funds.

Money market funds were basically invented to get around banking rules and they've become very important and they've had very little, practically no regulation.

I think that needs to be fixed up. If you have that group of institutions which are saying put your money with us, we'll always pay you back at par, you can write a check whenever you want to, you can move your money right away, that's a banking function. They ought to be regulated more or less like a bank.

They got into trouble during the crisis and had to be rescued which reinforces the point.

But there also can be arbitrage between countries if we have certain capital standards in the US and much weaker capital standards in London, business will move to London or if we say banks can't do hedge funds and in London they can do, then people will move to London.

If the German banks want to do a lot of proprietary trading and we think it is not appropriate for American banks then it creates tensions.

**Eurofi: There is indeed a lot of talk about hedge funds in Europe also, with a project of Directive**

**Paul Volcker:** Hedge funds will end up in my opinion being registered in the US above some amount.

I think there will be some reporting of their activities, of their exposures. Just how far that goes remains a big question.

I don't think it has to go terribly far but it should go far enough so that you know if some particular institution has got out of bounds and presented a real risk and you should be able to do something about it.

