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Lessons Learned: A Conversation with Paul A. Volcker

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Lessons Learned

A Conversation with
Paul A. Volcker

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On March 26, 2019, Andrew Metrick, the Janet Yellen Professor of Finance at the Yale School of Management and Founder and Director of the Yale Program on Financial Stability[1] *sat down with Paul A. Volcker to discuss his perspectives on the Federal Reserve, central banking autonomy, "too big to fail," and how his perspectives on these topics have changed over the decades.*[2] *It turned out to be one of the last interviews given by the former Chairman of the Federal Reserve System who passed away on December 8, 2019, at the age of 92.*

An Esteemed Legacy

During the 2007-09 financial crisis, the government's interventions to shore up the collapsing financial system were unprecedented as to scale and quantity. Support to specific entities was often discussed as being made on the basis that the entity was "too-big-to-fail," a term first coined in 1984 when the government intervened to save Continental Illinois National Bank and Trust Company, a large national bank that was about to fail. It would have been the largest bank failure in U.S. history at the time and would have remained the largest until the 2007-09 crisis. The Federal Reserve coordinated with the FDIC to save Continental, the rescue of which gave rise to the term "too-big-to-fail."[3]

Paul A. Volcker was Chairman of the Board of Governors of the Federal Reserve System during the administrations of Presidents Jimmy Carter and Ronald Reagan from August 1979 to August 1987. In 1984, he was instrumental in the decisions and actions taken to save Continental Illinois. Previously, Volcker had also, from August 1975, served as President of the Federal Reserve Bank of New York, where he was actively involved with monetary policy decision-making processes and became a proponent of monetary restraint. He also served

[1] Members of the Yale Program on Fincial Stability (YPFS) staff, Rosalind Z. Wiggins and Kaleb Nygaard, were also in attendance as was Gaurav Vasisht, then Senior Vice President and Director, Financial Regulation Initiatives for the Volcker Alliance. The YPFS website can be accessed here: https://som.yale.edu/faculty-research-centers/centers-initiatives/program-on-financial-stability.

[2] This transcript has been edited for clarity and some statements may have been reordered.

[3] See Haltom, *Failure of Continental Illinois* and Nurisso and Prescott, *The 1970s Origins of Too Big to Fail* discussing earlier bank bailouts that employed too-big-to-fail themes.

as an economist with the Federal Reserve from 1952 to 1957 when he left to work in the private sector.[4]

Volcker was the proponent of the namesake, Volcker Rule (adopted in 2010 as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act), which limits proprietary trading by banks. Volcker was appointed by President Barack Obama as the chair of the President's Economic Recovery Advisory Board on February 6, 2009. He also was the founder of the Volcker Alliance whose mission is "to advance effective management of government to achieve results that matter to citizens."[5]

Continental Illinois and Too-Big-To-Fail

Metrick: Today we were hoping to talk to you about topics that we focus on at the Yale Program on Financial Stability where we study crisis fighting. Of all of the many things that you worked on, the decisions around Continental Illinois [National Bank and Trust Company] were really important at the time and important for the future. It only received five pages in the Silber Volcker book[6] but I detect in reading your book[7] that you're happy about some parts of it and unhappy about other parts of it. There are hints in the book that you wish you had objected more to certain things or done some things a little bit differently.

Volcker: There are a number of lessons to be drawn from that scenario. You know from the book or otherwise that at that time, the penchant of the Federal Reserve, or any other regulator, for effective regulation was not very great. At one point I think they had been worried about capital positions, but that had all died away. By the time that I became Chairman [in 1979] there weren't any capital requirements that meant anything.

We knew that Continental Illinois was in trouble after learning about a bank in Oklahoma, Penn Square Bank, that was having trouble. The Oklahoma bank had made all these oil loans and then pitched them off to Continental Illinois and another bank, Seattle First.

In the summer of 1982 Roger Anderson, the chairman of Continental Illinois, visited me on a fishing trip and told me they were going bust. At some point we said we were ready to lend them quite a lot of money.

We kept an eye on it, but I didn't think that Anderson was doing enough to fix their problem and I said as much to the lead director, but he deferred to Anderson. I remember that was

[4] Federal Reserve History, Paul A. Volcker.

[5] Volcker Alliance Website: https://volckeralliance.org/.

[6] Silber, William, l., *Volcker: The Triumph of Persistence* (2012).

[7] Volcker, Paul, *Keeping at It: The Quest for Sound Money and Good Government* (2018).

typical of the kind of strength of banking regulation and of the seriousness of which directors and so forth took supervision.

The Oklahoma bank, Penn Square Bank, had preceded this by about a year. We finally let that go, but they had almost no uninsured deposits, so there wasn't much [good business] about it except that one of the big depositors was a credit union of the U.S. Congress.

We had had this earlier situation with another bank, First Pennsylvania, right after I became Chairman. It was an interesting case because that was the first big failure. They had bought a load of long-term Treasuries and then they went sour. They had so many of them that it jeopardized the whole bank. In the end we arranged a rescue where, as a formality, some of the private banks put some money in with us so it looked like a private rescue.

That was the plan that I had in mind with Continental, which was a much bigger fish. So, we put the proposition to FDIC Chairman, William Isaac.

We were together on this. The FDIC put in a little capital and we asked the banks to put some more capital, and we would provide all the liquidity it needed. Well, the banks weren't in the mood to put any more capital in.

So, we had to go ahead anyway. And I was unhappy about it at the time, I thought Isaac was probably right. I had to go get an honorary degree that day at Columbia, and if I didn't show up….

Metrick: They would know something was wrong with Continental Illinois.

Volcker: Right. So, we left it to Isaac to arrange it all. And when I got back it was basically all arranged with one difference, he was going to guarantee all the deposits.

Metrick: Even the uninsured ones.

Volcker: Yeah, which, as a matter of policy I didn't want to do. I thought if the FDIC put in some more capital, the Federal Reserve would pledge to provide all of the liquidity and so forth, and things would straighten out without formally guaranteeing the deposits. But Isaac wanted to be sure, and he may have been right. He thought he was protecting the FDIC by going all the way.

I don't remember any debate about this, but the way he put in the capital included protection for the subordinated debt of the holding company as well. We didn't want to do that, but that was Issac's decision. So, the bank stumbled along and eventually got sold to some company and then it disappeared.

On the Role of Financial Supervision

Metrick: You hinted about the role of Fed supervision during the time of Continental Illinois as being very different from its monetary policy function. Care to elaborate?

Volcker: Continental Illinois was an example of a lack of effective supervision that existed back in 1984. It was all an illustration of what the matter with the regulatory system was. You had three regulators for the bank (the Fed, the FDIC, and the OCC was the third because it was a national bank) and certainly Continental looked at the Fed as the principal supervisor as they should have. At the time, I also thought that we were the premier agency in terms of supervision. But we were not doing a good job, nobody was.

I never read the book, *The Secrets of the Temple,* because I knew it was anti-Federal Reserve, but it's actually a very knowledgeable book. So, in this book the author interviewed Chuck [J Charles] Partee, who was head of the Federal Reserve staff for many years. He was put on the Board, which is a precedent in itself.

The author of the book interviewed him, and the author says that he thought we were very efficient in dealing with inflation, but he said, "Even if I grant your case that inflation was an enemy and you had to deal with it, you could have dealt with it more effectively if you used your supervisory tools instead of putting us all in a recession. Why didn't you do that?" It's a good question.

You are politically exposed, particularly when you're tightening up. But by and large, at the end of the day people know you're responsible for monetary policy and they don't really lobby you that much.

In supervision, they lobby the hell out of you. And all the lobbying money goes into supervision and you don't want to take on two enemies at the same time.

The supervised is never happy, and the supervisor is never happy, and it's just as true today. This continues to be a big problem today. How do you effectively supervise these institutions?

It's just very hard to get a Federal Reserve Bank to toughen up its supervision. I think it's probably better now than when I was first there. The Presidents of the Federal Reserve banks weren't so noisy as they are now on policy and so forth.

The Presidents have a dilemma. They want to be an established member in the business community in Kansas City. They want to be friendly; they want to be on the Chamber of Commerce. And you don't get to be a respected figure in Kansas City if you're attacking, or seen to be attacking, the local banks in Kansas City.

It's not a comfortable place to be, but the Reserve Banks can hide behind the Board regarding the supervisory responsibilities.

Metrick: And not be so tough on their own banks?

Volcker: Right. But, once in a while you get a tough regulator. Dan Tarullo—now he was the toughest supervisor I think the Federal Reserve had. Dan Tarullo was very experienced, very knowledgeable. And Tarullo wasn't brought up in the banking world; he was a lawyer.

Metrick: But you think he did a good job?

Volcker: I think he made a difference, he made it more consistent and toughened it up and so forth.

I love to describe this experience Janet Yellen had when she was being quizzed by this government report about supervision when she was the president of the San Francisco Federal Reserve Bank. The conversation, not quoting directly, went something like this. They said, "We understand Mrs. Yellen, that you're one of the people who called attention to the deteriorating mortgage market and subprime loans."

She said, "Thank you for mentioning it; that's true."

Next question, "Why didn't you do something about it?"

Yellen says, "Well, it wasn't the responsibility of the San Francisco Fed. It was up to the Board. We mentioned it to Mr. Greenspan, but they weren't much interested, and it wasn't really our business anyway, so I didn't get aggressive and the Board was not aggressive."

It was a good question, and the Partee answer [splitting-off the regulatory role from the Federal Reserve] was compelling. I strongly believe that the Federal Reserve ought to be the principal regulator, but when you listen to Partee's answer you begin wondering whether we ought to have a special regulator. But the British tried that.

Metrick: And it didn't work.

Volcker: They fell completely on their face because that independent, special regulator was more overwhelmed by lobbying than the Federal Reserve would be.

But how do you deal with this problem? You have it today. It's not going to go away, so what do you do? That's what you're struggling with still.

Deciding Between Non-Ideal Choices

Metrick: Yes, that's what we're struggling with. So, what I think I'm hearing you say is that in the Continental Illinois case, because of how weak regulation was going into it, the situation just had no good choices. And ultimately, you're not happy with the fact that some too-big-to-fail beliefs got created by what happened, but at the same time you don't have a specifically different path that you think would have worked better.

Volcker: No, I don't. The thing I disagreed with was, I wanted to put so much firepower behind it, but I didn't want to guarantee everything. But it didn't make much difference. If we had not guaranteed everything, I think the same thing would have happened.

Metrick: So, if you had done the alternative strategy of, "we're not going to make this statement about guaranteeing everything, but the Federal Reserve is going to lend, lend, lend…" It wasn't the statement that created the belief, it was the firepower.

Volcker: Isaac's issue was, "Okay we, the FDIC, don't guarantee everything. You, the Fed, are going to put in all this liquidity. But if it goes bad, we've [the FDIC] got to pick up all the mess, and the Federal Reserve will go home with all the collateral." And he was absolutely right. If it had happened that way, he would have been right.

And he said, "That's not going to happen."

Metrick: It sounds like, with regards to the FDIC's specific decisions, you would have done things a little bit differently, but you think it would have engendered basically the same result in the market.

Volcker: I don't know. Suppose in the original plan the banks had put in a billion or so and the FDIC had put in two billion.

The Federal Reserve would have put in the liquidity. There was some discussion of this scenario, but the banks turned it down. Whether the appearances of that would have modified the too-big-to-fail rhetoric, I don't know. The stockholders did fail.

Metrick: Yes, and that's an important distinction, the same thing happened in the recent crisis. Stockholders often got hit badly. But the big alternative would be to have let them go. And your view was that that would have led to real panic.

Volcker: Continental was a big correspondent bank in the Midwest, so it probably had 400 little Western, Midwestern banks that had a big investment in it, and it had those big oil loans, which would have been exposed, which eventually were exposed anyway. That exposure killed First Seattle Bank. Chase Bank had a lot also. I don't know what would have happened to Chase if Continental Illinois had failed. Chances were very high that you would have had a run on some of the other banks and you certainly would have had runs on some of the small banks. You can say, "So what? They're mostly FDIC insured and so forth…" But it sure would have shook up the system. How much it would have shaken up the system, I don't know.

Metrick: Enough that you didn't want to risk it.

Volcker: That's for sure. Not on my watch.

The Federal Reserve as Regulator was Different Then

Metrick: Now you had talked a little bit I think in one of the events that you came into at Yale about how you had gone out to Chicago earlier to try to get Continental Illinois to get their act together. Can you reflect on that?

Volcker: Actually, it was just a routine visit. Right after I became the new Chairman of the Federal Reserve, I was visiting the Chicago Reserve Bank.

While I was out there, I looked at the position of First Chicago and Continental, and I said I want to talk to those guys. I had both the Chairman and a Director in the room. I said, "Look here, you're undercapitalized, you got to get your capital up." Here I was, brand new Chairman of the Federal Reserve. I was going to be the boss, "You got to get your capital up."

And they basically said, "You have no authority over our capital." Which at the time was a debatable point, whether we could have used our general supervisory authority. But they told me, "You don't have any authority over our capital."

If you went back ten years earlier the Fed did have a formula for capital, but nobody followed it and they finally dropped it.

So, I say "We're going to get you guys supervised." And that got me off on this capital business. But I admit being a little shocked at the rude treatment as the new Chair of the Federal Reserve.

I'll tell you another similar story. Years earlier, when I was the brand-new President of the Federal Reserve Bank of New York, I'm sitting in my little office and the First Vice President comes in and sees me and he says, "Tomorrow we have our annual lunch with Citibank."

"Having lunch? What're we having lunch for?" I ask.

"We get together and discuss what's going on in the market and what problems they foresee."

"Do you use this to get them in shape, with capital?"

"No, no, this is just chatting about good customer relationship."

So, I say, "Let me see their goddamn balances."

He gives me the balance sheet. And I look at it and I don't understand it. I'm thinking he gave me the wrong bank. It says National Citi, but I don't recognize any of the figures. "What's going on here?"

He said, "Oh, that's just the domestic bank, that's all we look at."

And at that point Citibank was probably as big as its domestic bank, but they didn't look at that. "Who looks at that?" I asked.

"The Comptroller looks at that."

"Do you ever consult?"

"No."

This is the famous time when they came around and told me quite seriously, "Citibank didn't need any capital. Why do we need any capital? We gain profit every year."

They actually had a memorandum supporting this theory. They believed it.

Metrick: If we make money every year, why would we need any capital? There's no risk that we won't make money.

Volcker: Exactly.

Metrick: So, if you look now at the decisions that were made in 1984 around Continental Illinois, and you were advising yourself—so Paul Volcker 2019 is advising Fed Chairman Paul Volcker 1984 (who was still a little green at the job)—would you recommend anything differently? Other than not getting the honorary degree from Columbia, so that you would be there for everything. Was there anything you think you would do differently having seen what then happened 35 years later?

Volcker: Well I'm sorry that we didn't guarantee the nonbank holding company. They had maybe $400 million or something of obligations to the holding company that they were selling as the crisis unfolded. The bondholders, they were selling…They had bought back half of those ventures, bonds, whatever they had. I discovered that just a few days before and I said, "Stop it, you can't…"

Metrick: Buying them back at discount.

Volcker: Yeah, you're not going to buy your liabilities back with Federal Reserve monies. It's ridiculous. So that's why there was still a couple hundred million leftover, which they got guaranteed. It was a little messy.

The Status of "Too-Big-To-Fail" Today

Metrick: Although Continental Illinois happened in 1984, "too-big-to-fail" played a significant part in the 2008-09 crisis. What's your assessment of where we stand today on this issue of "too-big-to- fail," after all the legislation that you were part of, where do you think this stands?

Volcker: Well I would like to think, maybe overoptimistically, that with enough cooperation in London and elsewhere, you could try out the authorities that the FDIC has, Title II, the Orderly Liquidation Authority.

People know that it's there. It deals with the stockholder problem. It permits an effective bailout of the debt holders and effectively kills the stockholders. I think politically that's sellable. I see that it could work.

Metrick: What you said around the time of Continental Illinois I think is still an issue today, which was something along the lines of, "We could probably handle one $40 billion bank going down, but if it's multiple $40 billion banks, it's going to be a real problem." I think the sense that a lot of people have about the Orderly Liquidation Authority is that it could maybe work in an idiosyncratic special case, but in a real systemic crisis we would need something else.

Volcker: Well, I suppose. Maybe you could gamble one bank without a systemic crisis, but if that comes at a time when it's not just one bank, when other banks are also on the edge, then certainly at that point you're going to have a run by the stockholders. The question is, would you get a run by the people who weren't protected?

Metrick: And what effect would a run have?

Volcker: The banks are so big now. Back in those days, you forget, even the biggest banks were nowhere near the size of these behemoths. Growth came very quick in the 1990s when interstate banking was permitted. I remember Walter Wriston always used to complain in his testimony that Citibank couldn't do well and the American banks couldn't do well, because of those big Japanese banks. "We're not big enough," he'd say. Well, we changed that up.

Metrick: Yes, we did.

Volcker: Unfortunately.

Metrick: The Japanese banks had their own problems.

Volcker: The Japanese banks had their problems. And now we have the big banks the Japanese used to have. This all led up to finally getting international bank capital standards, which is still better than what we had then.

The Impact of Politics on Regulatory Effectiveness

Volcker: Ultimately, it's just a human problem. How do you regulate something tight enough to be effective without creating such a political rumpus that you can't sustain it? Regulators tend to overdo it, and the banks overdo the risk taking, and it's hard to find the right balance. That's true of regulation everyplace. You've got to have a very strong regulator to stand up against the congress and the lobbyists, but I don't know how you get them, nobody wants them.

In my view, the agency that really screwed things up most obviously was the SEC.[8]

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[8] Pursuant to its Consolidated Supervised Entities (CSE) program, the Securities and Exchange Commission (SEC) regulated independent investment banks including Bear Stearns and Lehman Brothers. The agency was criticized by many parties including the Financial Crisis Inquiry Commission (FCIC) and the Lehman Brothers Bankruptcy Examiner for inadequate supervision, for not restricting the firms' risky businesses, and for allowing undue leverage and insufficient liquidity (Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States 2011; Valukas, Anton R., Lehman Brothers Bankruptcy Report 2010).

And they just claimed that their authority, which they paid no attention to, wasn't nearly adequate. But they didn't want to give it up, when they were regulating the most volatile part of the financial system. And we had the weakest regulator....

Metrick: In the most dangerous part of the system.

Volcker: Exactly. And it's pathetic reading this stuff from the Federal Reserve. I guess Greenspan said, "Well, that was the SEC's business."

And I remember there was a provision in the law that I spoke against. It said you got a conflict: you're in the bank, now who's going to regulate the broker-dealer in the bank? It ought to be considered in the bank, so it'll be the Federal Reserve. At that point the SEC was under the jurisdiction of the Commerce Committee, and the Commerce Committee didn't want to give up the jurisdiction, and the SEC didn't want to give it up either.

Reflecting on Federal Reserve Independence

Nygaard:[9] One of the most exciting and relevant parts of your book from last year was your experiences interacting with the Reagan administration. I'm wondering if you have any advice for the current Chair, or a future Chair, that is trying to learn the dance steps of the political game of central banking.

Volcker: The Reagan administration had very philosophically odd views on how the economy worked. The fortunate part was that it was divided between the monetarists and the supply-siders, and they hated each other even more than they disliked the Federal Reserve. So that was a great help.

They didn't really make a coherent attack on the Federal Reserve, but there was a kind of uncertainty and tip-toeing around when Reagan first came into office.

Arthur Burns (who served as the Chairman of the Federal Reserve from 1970 to 1978) had been with some Reaganite economists planning the new administration before Reagan took office. It was Bill Simon, Beryl Sprinkel, and Walter Wriston, and three or four others not very sympathetic to the Federal Reserve's point of view. I guess there was some comment made, "We should get rid of the Federal Reserve, blah, blah, blah, blah." And Arthur Burns flew back to Washington and told me, "You've got a terrible problem. All of these guys are going to come in and they want to defrock the Federal Reserve."

So, I didn't know quite what to expect, I had not had any contact with them. But immediately when the administration began, a guy who'd been at that meeting, a prominent Republican in Congress and an economist from California said, "the President wants to come and have a meeting with you here in your office."

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[9] Kaleb Nygaard is Research Associate, Yale Program on Financial Stability.

And I said, "that's nice of him. I'd be glad to meet the president, but he shouldn't come here. That's very odd, and people will interpret it as the first blow by a new administration if they come into the Federal Reserve." This guy, I think, genuinely didn't understand my reservation. I said, "Look I'm glad to meet the President. We'll go over to the White House anytime he calls."

He didn't want to do that for some reason. We ended up with this most peculiar meeting at the Treasury. We met on neutral grounds at the Treasury. There must have been ten people sitting around the room. And it all went alright. Reagan didn't have any very strong views about it. And somehow, we got along okay and had a few interactions, I guess. We went out and met the press together, and there was a very nice meeting and so forth. And he went away, and I never heard from him. So, we survived reasonably comfortably.

James Baker and the Latin America Crisis

Metrick: But there was another meeting, where they called you over and Jim Baker talked to you, with Reagan just sitting there.

Volcker: That was the strangest thing. Somebody later asked Baker about that meeting. I don't know what he can say. He can't say it didn't happen because he would know that I might bring up contemporary evidence that it happened. But he said, "I don't remember." And that may be true.

Metrick: That he doesn't remember it.

Volcker: This is ten years later, fifteen years later. I got along with Baker. We had an uneasy but not openly contentious relationship. He wanted to control exchange rates, and he couldn't control the exchange rates without the Federal Reserve, so there was a certain amount of interaction between us. But he was very sensible.

While he was in office, he had the international crisis, and Reagan didn't know what to do. We'd been through a few crises so we couldn't just let Mexico go bankrupt or we will have a run on every other Latin American country that was in the same shape.

So, in the short run, he was helpful; but he got uncomfortable. He was visibly uncomfortable about doing things that were unorthodox from the standpoint of his own staff who were of the opinion to, "Let them go broke."

I remember that even I was feeling a bit uncomfortable because rescuing Mexico, Latin America was not the prime responsibility for the Federal Reserve, but somebody had to do it. And so, I thought we better get straightened out, so why don't we go and see whether the President will bless this operation directly. And we went to see Baker, and he prepared a little memorandum for the President, and he said it sounds fine, "Go ahead and do what you're doing."

And, as I recall, the administration never interjected in the rescue of Latin America. Baker got interested in it when the immediate crisis was over, and we had negotiated all these rescue operations that we were trying to get. We put in place different policies in Mexico and Argentina and Brazil and so forth and Baker was obviously interested in that, so on that side we got along okay. They called it the Baker Plan. He wasn't too happy about that. He correctly told somebody that it was the Volcker Plan. We were bringing in the World Bank and other official agencies to help out. It was not a plan that was going to last. It was carried on for only two or three more years. So overall, it was a mixed bag with Baker. But he's both a wily politician and sensible on the policy side.

Metrick: How do you think we are going to solve the too-big-to-fail problem?

Volcker: I've come to the conclusion that in a way the regulatory authority is more important than the monetary policy authority. In this day and age, monetary policy is pretty straight forward one way or another. You tighten or you ease.

Metrick: Yes. It's a much more interesting job to be thinking about the regulatory side now.

Volcker: It's much more politically complicated. And you're right, it's not just in the financial world. But it's true that in the financial world you're never going to get harmony between the regulated and the regulator. And if you have harmony you're not in a very good spot.

Metrick: If the industry isn't complaining, then something's wrong.

Volcker: That's right. So, I don't know how you fix the problem inherent in the system. I mean that's what's a little disconcerting now because we have this Class-A crisis in 2008, which was only ten years ago, but the worms are [back] at work trying to do what they can do. In some cases, they have a perfectly legitimate gripe, but they have a lot of illegitimate gripes too.

Metrick: I like what you said about the Volcker Rule when it first came out and the banks complained about how complicated it was. You said, "Yeah it's way too complicated, the banks got exactly what they wanted." Which is to say, they wanted something that was complicated, so they could complain about it and game it.

Volcker: That's part of the problem, neither side trusts each other. Take that rule, any banker knows what the hell a proprietary trade is. If they don't, they ought to be kicked out on the grounds that they don't understand banking.

I was just reading the book *Liar's Poker*[10]. This innocent guy just graduated from Princeton he goes down there and he's going on page after page after page about how they're screwing their customers.

[10] Liar's Poker by Michael Lewis (2010)

Regulating International Banks

Wiggins:[11] You were there when you say Citibank was just becoming a big international bank. Now, all of the banks are international and huge, yet the regulation is still by country. What is it that you think central bankers can do better to be prepared to cooperate to regulate these large global institutions?

Volcker: Well, my impression is that it's a lot better than it used to be. Citibank, to its credit, has been on the verge of bankruptcy four times. And they required official help four times to avoid bankruptcy. But they were a big international bank back when I was a young man, and they did it pretty well, I think.

Then you look at the problem like what I was just reading about. Remember BCCI (Bank of Credit and Commerce International)? It's complicated. It was not a big bank; it wouldn't bring down the banking system. But it was a fraud. And Federal Reserve had finally approved purchase of a bank in Washington, and then they put a bank in New York. And then they had to have a bank in London, their biggest was in London. And its headquarters were in Luxembourg, which did no supervision whatsoever. Everybody else tucked behind it and said, well, Luxembourg is a major city... and they got in big trouble.

It became a kind of scandal because of the Arab connection, and I just remember it wasn't the happiest time. I knew nothing about it. I always fussed about why in this case the legal department—which was always tougher than the regular side of the Federal Reserve—why are they taking so long to make this decision about permitting them to buy this bank in Washington? Then they finally permitted it.

And you know who they hired as their representative in the United States? Clark Clifford, who was a great friend of Harry Truman and so forth. He was their representative in the United States. It finally ended up in a court suit in the United States, but they should have had one in London. The Bank of England had done practically nothing. They were worried about it, but they didn't do anything. And this is a perfect example of the question. It was below my radar screen because it was not a big bank, but while my lawyers were suspicious, they hadn't done anything very identifiable at that point. I guess they thought they had no grounds at the end for not permitting it.

But it ended up in court. I can't remember just what the issue was, but they won, in the sense that they didn't lose. And I don't know why. Because the case is very strong that they were corrupt, and Federal Reserve Bank of New York got involved, and somehow, they got by with it.

But this was much different than what I described when I became President of the FRBNY in 1975. There, I had the balance sheet for only the domestic bank and nobody knew about the

[11] Rosalind Z. Wiggins is Director & Senior Editor, Yale Program on Financial Stability

foreign parts. With BCCI, London had a big office; they had dozens of offices around the world, but nobody was paying any attention, and everybody was jealously hanging on to their own responsibilities or interests. But now I think that cooperation is better. But I don't know really where it stands.

There was a lot of cooperation between the FDIC and the Bank of England. Then that's kind of dissipated to some extent.

Metrick: I think the cooperation right now is at its highest level that it's ever been internationally, but we still don't know if it's adequate.

Volcker: I'm sure it works good for a while. I hope it still does; it's very sensible. So, we may have better cooperation between the English and the Americans and the Scandinavians and the French, then when we deal with the SEC.

Monitoring Systemic Risk

Vasisht[12]: Mr. Volcker, the Treasury Department has put out a change in its guidance for the Financial Stability Oversight Council (FSOC) in designating SIFIs (Systemically Important Financial Institutions) to prioritize activities-based regulation. I'd be curious to know what you think about that change, given the current regulatory structure, whether it makes sense to move towards an activities-based system. You might remember we talked about activities-based regulation in some of the work we've done—looking at the activities that institutions are engaged in as opposed to the institution itself. So, you wouldn't look at, for example, AIG, you would look at securities lending. You would look at repo. You would look at products. You would look at the broad activities that these institutions are engaging in to see if those activities need to be regulated differently, if heightened safeguards need to be imposed on those activities.

Volcker: Well, how do you know until there's an accident?

Vasisht: That's right.

Volcker: I mean it's amazing what you don't know until it goes bad. I suppose if you had that rule in effect before the big crisis and the big insurance company had this operation in derivatives, would they have spotted that?

Vasisht: I don't think so.

Metrick: That's why, ultimately, while it makes a lot of sense to regulate activities, and we should be looking at a lot of activities, the people who are in favor of regulating

[12] Gaurav Vasisht was at the tie of this interview Senior Vice President and Director, Financial Regulation Initiatives for the Volcker Alliance.

activities just don't want us regulating institutions. They realize that the institutional way is the way that has power and teeth, so it's a little bit of a last refuge of the scoundrel, to recommend that.

Volcker: I remember when I stopped being Chairman of the Board and I became head of the Group of 30. They were just putting out a report, which I had nothing to do with. It was about derivatives, the first big report on derivatives. And you read that thing, and you would have thought derivatives were the answer to everything possible, every problem in the market. That this was the invention that would make everything safe and efficient and probable.

Metrick: That's what Greenspan thought.

Volcker: It's just that as Chairman of the group, I was supposed to sign it.

I said I am not signing it. And I made them change parts of it. It was still very warm towards derivatives, but it wasn't quite as bad. We took out at least 50 percent of all the compliments, but it didn't take very long for problems to arise with derivatives. It gets way beyond my comprehension, but it's a problem. I think it's a principal problem, banking regulation and securities. It's national regulation, I don't know how you get around it.

Metrick: The YPFS attitude, which is may be too fatalistic, is that we think we should work extremely hard on regulation and prevention, but we don't think that it's going to be possible to prevent, nor is it optimal, to prevent all financial crises. And thus, we need to be ready for the rescue side.

If I could ask one more question. Back to inflation fighting. When you made the decision to break the back of inflation. When you ultimately made that call, there were many people who were pushing back. What was it like inside the Fed? What was the staff saying to you? What were the other governors saying? Was it hard to get to a consensus?

Volcker: Not for a while, because once we got hooked, you know we adopted this more humanist approach and there was a split on the Board; I wasn't expecting it. What I didn't expect in particular, was that the market would react so adversely to the fact that there'd be no more tightening because there were three members of the Board objecting. [You take one more and you can go home.] So that was counterproductive. So, you have to shake this up somehow.

There was always a group of three or four of the Reserve Bank Presidents that were much more monetarist-minded than the Board was. And you had three very hawkish Board members far from me. That's why I was taken aback by this market reaction. Henry Wallich was never going to do anything except vote anti-inflation, neither was Phil Coldwell, nor Fred Schultz; I had three sure votes.

But I guess they were shocked by the market reaction, so they were ready for something new and fresh, and they all went along with the whole works. No point in holding back, so raise the reserve requirement, raise the discount rate.

Metrick: The market spooked enough people that that gave you the cover.

Volcker: Once I got hooked; I got hooked. Even Partee got hooked after a while, but [that's] another lesson about regulation. President Jimmy Carter wanted to say he supported us, and why don't we have credit controls? It was a mistake to have credit controls, and we didn't want it. The President was supporting us.

So, we thought we'd do what we could. We made the credit controls as ineffective as we could possibly make them, but that's not the way the market took up, just the opposite.

It was overkill, and it costs us six months. But then once you were hooked, you were hooked. By the middle of 1982 we were running out of steam, I tell you. But just in time the inflation rate came down.

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