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Volcker Pushes for Reform, Regretting Past Silence

By LOUIS UCHITELLE

JUST before the Fourth of July weekend, Paul A. Volcker packed his fishing gear and set off for his annual outing to the Canadian wilds to cast for Atlantic salmon.

He left behind a group of legislators in Washington still trying to nail down a controversial attempt to overhaul the nation's financial regulations in the wake of the country's most serious economic crisis since the Great Depression.

A well-regarded lion of the regulatory world, Mr. Volcker had endorsed the legislation before he went fishing, but unenthusiastically. If he were a teacher, and not a senior White House adviser and the towering former chairman of the Federal Reserve, he says, he would have given the new rules just an ordinary B — not even a B-plus.

"There is a certain circularity in all this business," he concedes. "You have a crisis, followed by some kind of reform, for better or worse, and things go well for a while, and then you have another crisis."

As the financial overhaul took final shape recently, he worked the phone from his Manhattan office and made periodic visits to Washington, trying to persuade members of Congress to make the legislation more far-reaching. "Constructive advice," he calls it, emphasizing that he never engaged in lobbying.

For all of what he describes as the overhaul's strengths — particularly the limits placed on banks' trading activities — he still feels that the legislation doesn't go far enough in curbing potentially problematic bank activities like investing in hedge funds.

Like few other policy giants of his generation, Mr. Volcker has been a pivotal figure in the regulatory universe for decades, and as he looks back at his long, storied career he confesses to

some regrets, in particular for failing to speak out more forcefully about the dangers of a seismic wave of financial deregulation that began in the 1970s and reached full force in the late 1990s.

Despite his recent efforts to ensure that the financial legislation might correct what he regards as some of the mistakes of the deregulatory years, he's concerned that it still gives banks too much wiggle room to repeat the behavior that threw the nation into crisis in the first place.

Some analysts share Mr. Volcker's worries that the proposed changes may ultimately not be enough.

"It could be we will look back in 10 years and say, 'Wow, Volcker really changed the tone of the debate and the outcome,' " says Simon Johnson, an economist at the Massachusetts Institute of Technology and a historian of financial crises and regulation. "But I kind of worry that is not going to happen."

Hear, hear, says Mr. Volcker.

"People are nervous about the long-term outlook, and they should be," he says.

AMONG the tools that Mr. Volcker has been able to deploy when regulatory debates heat up is the public support he enjoys in financial and political circles.

He earned that esteem over many years, and is famously credited for making tough-minded choices to tame runaway inflation as Fed chairman from 1979 to 1987, when he served under Presidents Jimmy Carter and Ronald Reagan.

At the age of 82, Mr. Volcker is from a generation of Wall Street personalities who accepted strict financial regulation as a fact of life through much of their careers. In his recent push for more stringent financial regulations than he believed Congress — and the Obama administration, for that matter — were inclined to approve, he lined up public support for a tougher crackdown from other well-known financiers who are roughly his age, including George Soros, Nicholas F. Brady, William H. Donaldson and John C. Bogle.

His most visible contribution to the current regulatory overhaul effort is what has come to be known as the Volcker rule, which in its initial form would have banned commercial banks from engaging in what Wall Street calls proprietary trading — that is, risking their own funds to speculate on potentially volatile products like mortgage-backed securities and credit-default swaps.

Such bets added considerable tinder to the financial conflagration that erupted in 2008. Many went horribly awry, and the federal government used taxpayer money to bail out banks, Wall Street firms and even a major insurer.

“I did not realize that the speculative trading by commercial banks had gotten as far out of hand as it had,” says Mr. Volcker, explaining why he first proposed the rule 18 months ago.

Congressional handicappers and Wall Street originally gave the Volcker rule a slim chance of becoming part of the overhaul bill — until, in fact, it got solidly on track to do just that.

Mr. Volcker thinks that Congress has watered down his trading rule — more on that later — but rather than roar in protest, he has resigned himself to the present shape of the Volcker rule as well as the overall legislation.

“The success of this approach is going to be heavily dependent on how aggressively and intelligently it is implemented,” he says, emphasizing that a new, 10-member regulatory council authorized by the bill will have to be vigilant and tough to prevent the nation’s giant banks and investment houses from pulling America into yet another devastating credit crisis. “It is not just a question of defining what needs to be done, but carrying it out in practice, day by day, bank by bank.”

The 2,400-page financial overhaul legislation, already passed by the House, is coming up for a vote in the Senate this week.

The Obama administration says it is now satisfied with the broader legislation, and in particular with the Volcker rule in its amended form.

“The Volcker rule was designed to make sure that banks could not engage in proprietary trading or create risks to the system through their investments in hedge funds or private equity,” says Neal S. Wolin, the deputy Treasury secretary. “We accomplished that.”

Some members of Congress who have backed the bill still say that it is not as restrictive as they would like, but that a more sweeping bill — one that also hewed to Mr. Volcker’s original conception — wouldn’t make it through the Senate, where the vote is expected to be close.

Representative Barney Frank, the Massachusetts Democrat who is chairman of the House Financial Services Committee, subscribes to that view. He says that there are stronger measures he would have preferred to see in the bill, including the original version of the Volcker rule, but

that political reality dictated otherwise.

“I would give the present bill an A-minus,” Mr. Frank says, “when you consider that six months ago people were saying the Volcker rule had no chance.”

Mr. Frank is quick to point out that Mr. Volcker signed off on the compromises that got the Volcker rule into the bill. Mr. Volcker doesn’t dispute that.

“The thing went from what is best to what could be passed,” he says.

THE financial bill has been routinely described in the news media and on Capitol Hill as the most far-reaching regulatory overhaul since the Great Depression, which in some aspects it may be. But it certainly falls short of re-establishing some of the strict boundaries that the earlier laws put in place.

Those laws, most notably the Glass-Steagall Act, forbade commercial banks (what are now, for example, Citigroup, JPMorgan Chase and Bank of America) and investment banks (like Goldman Sachs and Morgan Stanley) from mingling plain-vanilla products like savings accounts, mortgages and business loans with the more high-octane, high-risk endeavors of trading.

Such rules managed to keep the banks and the Wall Street investment houses — and the broader economy that depended on them — out of a 2008-style crisis for several decades. But the gradual unwinding of those regulations began in the 1970s as Mr. Volcker rose to prominence, first as president of the Federal Reserve Bank of New York in 1975, and then as Fed chairman.

Mr. Volcker says that most of the deregulation came after he left the Fed. His reluctance to deregulate contributed in part to his departure under pressure from the Reagan administration. His replacement, Alan Greenspan, openly campaigned to weaken and finally repeal Glass-Steagall, and President Bill Clinton signed the repeal into law in 1999.

Although Mr. Volcker opposed the repeal, he didn’t go public with his concerns. “It is very difficult to take restrictive action when the economy and the financial markets seemed to be doing so well,” he says of his silence at the time. “But eventually things blew up.”

He also says he failed to anticipate just how wild things would become, post-Glass-Steagall: “Those were the days before credit-default swaps, derivatives, securitization. All of that changed the landscape, and now some adjustment must be made.”

There were other, earlier silences. Starting in the 1970s, ceilings came off the interest rates banks

could place on most deposits and loans. A rising inflation rate made the ceilings impractical, and competition from unregulated money market funds was siphoning big chunks of deposits from the banks.

“The lifting of interest-rate ceilings was inevitable,” he says. “I was for doing it more gradually, but it got such a momentum that we moved the limits more abruptly than I wanted to.”

In the wake of those changes, banks were suddenly free to charge more for risky loans, and that encouraged risky lending. The subprime mortgage market grew out of this dynamic, as did the panoply of complex, mortgage-backed securities, credit-default swaps and heart-stopping leverage that finally produced the 2008 crisis.

In retrospect, Mr. Volcker regrets not challenging the widely held assumptions that underpinned much of this. “You had an intellectual conviction that you did not need much regulation — that the market could take care of itself,” he says. “I’m happy that illusion has been shattered.”

THE Volcker rule, in its initial, undiluted form, was an attempt to resurrect the spirit of Glass-Steagall.

The administration initially did not want to separate banks and investment houses, and wanted federal regulation and protections in place for both the Banks of America and the Goldman Sachses of the world. Mr. Volcker disagreed. Let Goldman Sachs and others trade to their hearts’ content, he argued in Congressional testimony last fall, and if they fail they can lose their own money, not get a dime in bailouts from taxpayers, and then be dismantled by the government in an orderly fashion.

Old-fashioned commercial banks that made loans to individuals and businesses were much more essential to the financial system, he argued, and deserved broader federal support than pure Wall Street trading shops.

But in exchange for that support, Mr. Volcker said, commercial banks had to agree to a partial resurrection of Glass-Steagall that corralled their trading activities. His hope is that the trading restrictions will make the nation’s banks embrace the business of commercial and consumer lending more fully and move away from speculative trading.

To encourage that shift, Senator Carl Levin, Democrat of Michigan, and Senator Jeff Merkley, Democrat of Oregon, co-sponsored an amendment to the financial bill that would have incorporated the Volcker rule with all of its original restrictions. Mr. Volcker even had a hand in

writing the amendment, so much so that Senator Merkley suggested, only half-jokingly, that it should be called the Merkley-Levin-Volcker amendment.

The White House, after resisting, signed on to the proposal, and so did Congress after much internal wrangling — but the legislation now contains what Mr. Volcker considers an annoying and potentially dangerous loophole.

Instead of forbidding banks to make investments in hedge funds and private equity funds, the amendment allows them to invest up to 3 percent of their capital in such funds, so long as the fund is "walled off" from the bank in a separate subsidiary.

Banks won't be allowed to leverage their investments by lending to a hedge fund; such a loan, if sizable enough, could endanger the bank if the hedge fund should fail. In addition, if regulators discover that a bank is overexposed to a given fund, they are required to intervene and, in some cases, may even be able to shut down the fund or restrict its activities, in order to preserve a bank's well-being.

But the lending restriction is not as clear-cut as it should be, cautions Senator Merkley.

"We have to get some clarification on that," he says.

Nor is it clear that a bank wouldn't try to come to the aid of a hedge fund or a private equity firm in danger of failing if that failure would also cause financial or reputational problems for the bank.

For all of that, Henry Kaufman, a Wall Street economist and a contemporary of Mr. Volcker, wonders how effectively regulators will enforce any of the bill's numerous mandates. "The legislation is a Rube Goldberg contraption," he says, "and there are very long timelines before the Volcker rule is fully implemented."

Whatever warts exist in the Volcker rule, its author says that other positive elements of the larger bill are still worthy and important.

"Don't take the Volcker rule out of perspective," he says. "It is one aspect of a broad reform, and it became a big issue because the administration initially disagreed."

MR. VOLCKER has had a lukewarm relationship with the Obama White House, where the approach to the economy and financial regulation has been dominated by Timothy F. Geithner, the Treasury secretary, and Lawrence H. Summers, director of the National Economic Council.

Both men were at the center of the deregulatory whirlwind that swept across Wall Street and Washington over the last decade or so, and analysts have considered them to be friendlier to Wall Street and less inclined to pursue tougher regulations than Mr. Volcker would be.

Mr. Volcker supported Mr. Obama in the 2008 presidential election, and the new president named him to lead his Economic Recovery Advisory Board, a group of distinguished outsiders with little real impact on White House policy — until Mr. Volcker publicly proposed the ban on proprietary trading by commercial banks.

After the proposal gained support outside Washington, the president embraced it and dubbed it the Volcker rule. That gave Mr. Volcker more access to the White House and the Treasury on regulatory policy, but people who work with him say that the White House doesn't regularly seek his input on other issues.

However complicated his relationship with Washington, Mr. Volcker says his personal life has taken a turn for the better. He had been a widower since 1998, until six months ago when he married Anke Dening, his longtime administrator, executive secretary, adviser and constant companion. Ms. Dening, who is German-born and speaks several languages, travels regularly with her husband and often serves as his interpreter.

When it comes to interpreting the financial legislation, Mr. Volcker says he remains less than impressed. "We have to have a regulatory system that reflects today's problems and tomorrow's potential problems," he says. "This bill attempts to do that. Does it do it perfectly? Obviously it does not go as far as I felt it should go."