Remarks by
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Video of the remarks (Courtesy: C-SPAN)

The famous American poet, Robert Frost, once said that the true test of a college student's chances, is when you know the sort of activity for which he'll neglect his studies. So the fact that all of you are here at 8 o'clock in the morning to hear a talk on financial regulatory reform, is a very promising sign!

Your new home for the McDonough School of Business is truly remarkable. I love the glass atrium. It gives you a window on a world where business gets more global every day, and in every way.

I understand the atrium also was intended to put business education on public display, for all to see. That's a very good idea. Transparency is an abiding value of our democracy. And in the wake of the current economic crisis, I'm also very big on more transparency in business, finance, and government. The fact is, if we'd had more transparency, we could have avoided some of the mess we're in, particularly regarding the structured finance and derivatives markets.

With that in mind, I want to talk this morning about how to create a more resilient, transparent, and better regulated financial system – one that combines stronger and more effective regulation with market discipline. Ultimately, our goal must be to end too big to fail.

To do this, we need to fix weaknesses in our regulatory system, and to work with our international partners to reform the resolution processes in other countries when large firms become non-viable. With these steps we can foster real market discipline and make international cooperation more successful.

Closing the gaps

It's very clear that one of the causes of the economic crisis is significant regulatory gaps within the financial system. Differences in the regulation of capital, leverage, and consumer protection, and the almost complete lack of regulation of over-the-counter derivatives, allowed rampant regulatory arbitrage. Reforms are urgently needed to close these gaps.

At the same time, keep in mind that much of the risk in the system involved firms that were already subject to extensive financial regulation. One of the lessons of the past few years is that regulation alone is not enough to control imprudent risk-taking within our dynamic and complex financial system. You need robust and credible mechanisms to ensure that market players will actively monitor and keep a handle on risk-taking. In short, we need to enforce market discipline for systemically important institutions.

In a properly functioning market economy there will always be winners and losers. So when firms, through their own mismanagement and excessive risk-taking, are no longer viable, they ought to fail. Preventing companies from failing ultimately distorts market discipline, including the incentive to monitor competing firms and to allocate resources to the most efficient ones.

Unfortunately, measures taken during the past year – while necessary --have only reinforced the idea that some financial firms are simply too big to fail. Today, we now have fewer players in critical areas of our markets. The market is even more concentrated and interconnected than before. And unless we adopt needed reforms, our system will be more, not less, fragile after this crisis.

Vicious circle remains

This too-big-to-fail doctrine creates a vicious cycle that needs to be broken. Large firms can borrow more cheaply and on more favorable terms because the market assumes the government will not let them fail. Equity investors also have relied on an implicit government guarantee – with an unlimited upside, but a very limited downside. In effect, the largest firms socialized their risks and costs – by not paying for equity and credit based on their true risk – while keeping the enormous profits during good times.

This creates equally enormous risks for the system. Big firms leverage their operations to make still greater profits, while investors and creditors become more complacent and more likely to extend credit and funds without fear of losses.

For senior managers, the incentives are even more skewed. Paid in large part through stock options, senior managers have an even bigger economic stake in going for broke, because their upside is so much bigger than any possible loss. And, once again, with too big to fail, the government takes the downside risk.

This has got to stop. We need a credible method for closing large financial companies without inflicting collateral damage on the economy.

I think it's time we took a chapter from Teddy Roosevelt's trust-busting age. We need to create dis-incentives for these firms to become so large and interconnected that their failure would threaten us all. Far from being rewarded with the prospect of government bailouts, systemic firms should be penalized with higher capital, assessments, and exposure to a tough resolution mechanism if they become non-viable.

Need for new resolution authority

To end too big to fail, we need an orderly and highly credible mechanism that's akin to the process we use to resolve FDIC-insured banks. When the FDIC closes a bank, what typically happens is shareholders are wiped out ... creditors take a substantial haircut, management is replaced, and the remaining assets of the failed institution are sold off.

The process is harsh. It's painful. But it works. It quickly puts assets back into the private sector, and into the hands of better management. And it limits the cost of the takeover to the FDIC's insurance fund. It also sends a strong message that investors and creditors face losses when an institution fails. So-called "open-bank" assistance for large complex firms should be prohibited. This assistance puts the interests of shareholders and creditors before that of the public.

If anything is to be learned from this crisis, it's that market discipline must be more than a philosophy for warding off needed regulation in good times. It must be enforced during difficult times. We have an effective process to close banks – but we do not have such a process to close large holding companies or other large firms, like Lehman. We need an orderly process for winding down these large, systemically important financial firms without imposing costs on taxpayers.

Unlike what we have now, a new resolution regime would focus on maintaining a failed institution's liquidity and key activities so it can be resolved without the near panic we saw a year ago. Losses would be borne by the stockholders and bondholders of a holding company, and senior managers would be replaced.

Make no mistake. I support the actions we took with the Federal Reserve Board and Treasury Department to stabilize the financial system. Lacking an effective resolution process for these firms, we did what we had to do. But going forward, open-bank assistance should not be used to prop up any individual firm, but only to give system-wide support. Our Temporary Liquidity Guarantee Program is a good example of system-wide support that prevented a deepening of the crisis.

Incentives to reduce size and complexity

In addition, firms that pose systemic risks should be subject to regulatory and economic incentives that require them to hold larger capital and liquidity cushions. Restrictions on leverage, and risk-based premiums on institutions and their activities, would be disincentives for growth and complexity that raise systemic concerns.

In addition, large financial holding companies should be subject to tougher prompt corrective action standards under U.S. law. And they should be subject to holding company capital requirements that are no less stringent than those for insured banks. As for off-balance-sheet assets and conduits, which were a major headache in the current crisis, these should be counted as on-balance-sheet risks.

Without these changes, we'll be forced to repeat the costly, ad hoc responses of the past year.

Systemic oversight council

We're also in need of a regulatory framework that's proactive, and identifies issues and trends that pose risks to the broader financial system. The new structure, featuring a strong oversight council, would monitor the financial system, from insurance companies to banks. By looking broadly across all of the financial sectors, the council will be able to adopt a "macro-prudential" approach.

The point of looking more broadly at the financial system is that reasonable business decisions by individual financial firms may, in the aggregate, pose a systemic risk. This is a classic "fallacy of composition" problem that cannot be solved by simply making every financial product or practice safe. Instead, rules issued by the council would be uniform for all parts of the regulatory system. The council would monitor how the rules are working and would have the power to take corrective action, if necessary.

In short, an oversight council would see the big picture, with a wide-range of views making it more likely we'd flag the next problem before it causes significant damage.

Other gaps

Another huge gap that desperately needs plugging is the lack of regulation of over-the-counter derivatives, like the credit default swaps that crippled insurer AIG.

We support Treasury's proposal to require standardized derivatives to trade on exchanges and settle through central counterparty systems because this will reduce the risk that a single market participant can trigger destabilizing contagion in the markets. However, we must go further to make sure market participants have strong incentives to move to standardized products – through capital, margin, and other incentives.

As I said at the beginning, transparency is absolutely critical. We must have more transparency in our capital markets – from securitization to derivatives – to give us a more efficient, resilient market. This requires regulatory diligence and it requires market mechanisms that support transparency. Never again can we permit the growth of totally opaque structures, like SIVs and CDOs, that mask the underlying assets, game the capital rules, and arbitrage ratings and regulatory requirements.

I support most of the Financial Accounting Standards Board's changes to bring more assets on balance sheet, to limit the opportunities for hiding assets in special purpose entities, and to require more balanced accounting treatment. These favor transparency. Some proposals, however, do not appear to advance the ball.

In some cases, marking banking assets to market prices doesn't make sense. When a bank is holding a deposit, a loan or a similar banking asset for the long-term, it shouldn't

have to mark them to market values that may vary widely over time. Extending MTM accounting to all banking assets takes a good approach for market-based assets, like securities, but extends it to areas where it doesn't accurately reflect the business of banking.

We don't need to deepen crises by inaccurately reporting so-called market values for loans and other banking assets. This introduces a level of pro-cyclicality that can have dire consequences when the accounting is divorced from reality. During good times, such an approach could inflate the true value of bank assets and capital strength. And during periods of market stress, losses could be exaggerated.

Moreover, given the idiosyncratic nature of the credit characteristics of individual loans, trying to determine a "market price" for many of them would be more art than science ... and of questionable utility to investors compared to cost accounting. In fact, the apparent "transparency" may be illusory because fair valuing assets and liabilities without any clear "market" prices may simply increase valuation discretion.

I would note that in a recent letter to the President, the oversight body for the International Accounting Standards Board recognizes that cost-based accounting is appropriate for certain financial instruments and that the IASB is not proposing that the loan book of banks be held at fair value.

We've been highly supportive of many if not most of FASB's accounting reforms. But on this matter, I strongly caution the FASB to carefully consider the full ramifications of requiring fair value treatment of bank deposits and loans held to maturity.

International Dimension

All of these reforms have a vital international component because our largest financial institutions operate on a global scale. They can operate through foreign branches, foreign subsidiary banks and trading operations, as do many of our largest banking organizations. So it's vital that we have a stronger, more durable world financial system.

All the reforms I have discussed today are just as important to the United States as they are for the G-20 and the other countries that make up our global system.

Leverage ratio and capital buffers

Let me focus on one major issue. I've long advocated for more and better quality capital to reduce the fragility of major banks. A key part of this is an internationally recognized leverage ratio – which provided a vital backstop to the U.S. capital framework during the crisis. It meant that U.S. banks came into the crisis with more capital than their foreign counterparts.

I applaud Treasury Secretary Geithner for his explicit support for stronger capital and an international leverage ratio. The U.S. has taken a prominent leadership role in pushing

for a stronger international capital regime, notably for the largest firms that pose the greatest risk.

This is critical. Global firms need more and better quality capital. And the U.S. must work with its friends to achieve a safer financial system.

Cross-border failures

Another part of a safer global system is a more effective way to close failing cross-border financial firms. Today there are no international laws or agreements for managing a financial crisis or a failure of a major cross-border bank. If one of these large banks fails, a variety of different national laws would apply.

This makes it very hard to predict what will happen. But very likely that cooperation between different countries where the bank operates will break down.

Just as in our domestic system, you must have an effective way to close failed cross-border firms. Countries must reform their legal frameworks so that big financial groups can fail in an orderly fashion, and not simply be bailed out.

The FDIC has been leading an international working group focused on precisely these reforms. The group's recommendations focus on creating national laws that can work together, avoid bail-outs, and prevent future crises. Tools like 'bridge banks' and greater commonality in national laws, requiring large firms to prepare 'wind-down' plans, and advance coordinated planning will reduce risk and increase systemic stability.

The next step is to keep the focus on reforming national laws. While many recognize the current need for reform, we must avoid complacency and forgetting the lessons of the crisis. The G-20 and the Financial Stability Board will be key players in keeping these issues before our trading partners.

Again, the goal is predictability, minimizing confusion and surprise for investors and consumers, which give rise to the panic that causes bank runs and a liquidity crisis.

Conclusion

So, am I confident that we'll recover, a year after Lehman's bankruptcy? Yes I am. It will be painful. It'll take some time. But we're starting to recover.

I deeply believe in this country. I believe in our commitment, our entrepreneurship, our innovation, our tenacity and our tough, hard-work ethic. So we'll work through this. And I hope there will be some positive things to come out of this.

I hope all of you who go into finance will become advocates for change, advocates for customer service, transparency, and long-term, sustainable growth. Your customers must believe they're getting a fair shake. You need to give them mortgages they can

afford, credit cards without the hidden fees, small dollar loans at reasonable rates, and checking accounts minus the usurious overdraft fees. Treating your customers fairly is how you build trust and loyalty, the hallmarks of any business relationship.

And I hope you will be advocates for compensation structures that reward long-term profitability and penalize quick-buck schemes that reward employees who put an entire company at risk for the sake of high, upfront fees.

I hope Wall Street has learned some of these lessons. I hope financial institutions have learned that long-term, sustained profitability can only come from products and services that have real value for businesses and consumers.

And to be sure, regulators need to be more vigilant and vigorous. There's a difference between "free markets" and "free-for-all markets". The government needs to set and enforce the basic rules.

And we're also looking to you -- our future business leaders -- to help us right the ship and steer us to calmer waters. So yes, we're going to get out of this. And with your help, we'll be much stronger in the years ahead.

Thank you very much.

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