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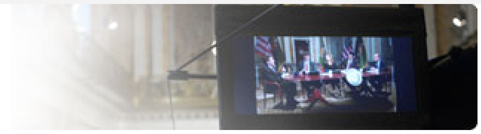

Remarks by Assistant Secretary for Financial Institutions Michael Barr on Regulatory Reform to the Exchequer Club Washington, D.C.

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As Prepared for Delivery

Members of the Exchequer Club, Paul Stevens, thank you for inviting me to join you today. I particularly want to thank Robert Kabel for hosting the reception, and Karen Thomas for that warm introduction. I am honored to be here to speak to the Exchequer Club of Washington, DC.

I would like to speak to you about where we stand today in the economy at large and the forces and incentives that led us into the current crisis. I would also like to begin a discussion with you on the sweeping set of reforms that the Obama Administration has proposed for our financial sector. In the weeks since the release of those proposals, the Administration has pushed forward this debate in testimony and outreach and continued to make our proposals concrete in legislation and regulation. Later today we will continue our efforts by sending legislation to the Hill that will require registration of all hedge fund advisers.

Where our Economy Stands Today

President Obama inherited an economic and financial crisis more serious than any President since Franklin Roosevelt. Over the last seven months, the President has responded forcefully with a historic economic stimulus package, with a multi-prong effort to stabilize our financial and housing sectors, and, in the past month, with a sweeping set of reforms to make the financial system more stable, more resilient, and safer for consumers and investors.

We cannot be complacent; the history of major financial crises includes many false dawns and periods of optimism even in the midst of the worst downturns. But I think you will agree that the sense of free-fall that surrounded the economic statistics earlier this spring has now abated. Even amidst much continued uncertainty, we must reflect on the extraordinary path our economy and financial system has taken over the past two years, and debate and discuss the path that it can and should take going forward. We cannot afford to wait. We must begin reform now.

Forces Leading to the Crisis

As we consider financial reform, we need to be mindful of the fact that those markets with the most innovation and the fastest growth seemed to be at the center of the current crisis. There is no doubt that taking the long historical view, at many turns we have seen a pattern of tremendous growth that has been supported by financial innovation.

But in this cycle, as in many times in the past, this growth often hid key underlying risks, and innovation often outpaced the capacity of risk managers, boards of directors, regulators and the market as a whole to understand and respond.

Securitization helped banks move credit risk off of their books and supply more capital to housing markets. It also widened the wedge between principals and agents – lowering underwriting standards and the incentives for due diligence.

Tranching of asset-back securities and the assignment of ratings to tranches of structured products by credit rating agencies seemed to give investors more control of the precise risk profile they were taking, but risk managers, corporate directors, and regulators did not account for the tail-risk that this crisis so painfully exposed.

Rapidly expanding markets for hedging and risk protection allowed for better management of corporate balance sheets and freed businesses to focus on their core missions; credit protection allowed financial institutions to provide capital to business and families that needed it, but a lack of transparency hid the movement of exposures. When the downturn suddenly exposed liquidity vulnerabilities and important counter-party risks, uncertainty froze even the most deeply liquid and highly collateralized markets at the center of our financial system.

It may be useful to think about our response to this crisis in terms of cycles of innovation. New products develop slowly while market participants are unsure of their value or their risks. As they grow, however, the excitement and enthusiasm can overwhelm normal risk management systems. Participants assume too soon that they really "know how they work," and more extreme versions, applied widely without thought to the differing contexts, and often carrying more risk, flood the market. The cycle turns, as this one did, with a vengeance, when that lack of understanding and that excess is exposed. But past experience shows that innovation survives and after a time renews once again.

Innovation creates products that serve the needs of consumers and growth brings new players into the system. Businesses and financial institutions have an important and ongoing need to manage their risks. Our financial system must maintain its role as an efficient way to allocate capital.

But innovation demands a system of regulation that protects our financial system from catastrophic failure, protects consumers from widespread harm and ensures that consumers have the information they need to make appropriate choices. Rather than focus on the old, "more regulation" vs. "less regulation" debate, the questions we have asked are why certain types of innovation contributed in certain contexts to outsize risks, and why our system was ill-equipped to monitor, mitigate and respond to those risks.

Our system failed to require transparency in key markets, especially fast developing ones. Rapid growth hid misaligned incentives that people didn't recognize. Throughout our system we had inadequate buffers – as both market participants and regulators failed to account for new risks appropriately. The apparent short-term rewards in new products and rapidly growing markets overwhelmed private sector gatekeepers, and swamped those parts of the system that were supposed to mitigate risk. And households took on risks that they did not fully understand and could ill-afford.

While our proposals identify sweeping reforms to the regulation of our financial system, we must also address an underlying crisis of confidence--for consumers and for market participants. We must create a financial system that is safer and fairer; more stable and more resilient.

Protecting Consumers

To rebuild trust in our markets, we need strong and consistent regulation and supervision of consumer financial services and investment markets. Two weeks ago, we delivered the first major portion of our legislative proposals to the Hill, proposing to create a Consumer Financial Protection Agency.

We all aspire to the same objectives for consumer protection regulation: independence, accountability, effectiveness, and balance -- a system that promotes financial inclusion and preserves choice. The question is how to achieve that. A successful regulatory structure for consumer protection requires mission focus, market-wide coverage, and consolidated authority.

Today's system has none of these qualities. It fragments jurisdiction and authority for consumer protection over many federal regulators, most of which have higher priorities than protecting consumers. Non-banks avoid federal supervision; no federal consumer compliance examiner lands at their doorsteps. Banks can choose the least restrictive supervisor among several different banking agencies. Fragmentation of rule writing, supervision, and enforcement leads to finger-pointing in place of action and makes actions taken less effective.

The President's proposal for one agency for one marketplace with one mission – protecting consumers – will resolve these problems. The Consumer Financial Protection Agency will create a level playing field for all providers, regardless of their charter or corporate form. It will ensure high and uniform standards across the market. It will focus on ensuring financial literacy for all Americans. It will end profits based on misleading sales pitches and hidden traps, but there will be profits made on a level playing field where banks and nonbanks can compete on the basis of price and quality.

If we create one federal regulator with consolidated authority, we will be able to leave behind regulatory arbitrage and inter-agency finger-pointing. And we will be assured of accountability.

Our proposal ensures, not limits, consumer choice; preserves, not stifles, innovation; strengthens, not weakens, depository institutions; reduces, not increases, regulatory costs; empowers, not ignores, consumers; and increases, not reduces, national regulatory uniformity.

Systemic Risk

Much of the discussion of reform over the past two years -- both in our proposals and among other commentators -- has focused on the nature of and proper response to systemic risk.

To address these risks, our proposals focus on three major tasks: 1) providing an effective system for monitoring risks as they arise and coordinating response; 2) creating a single point of accountability for tougher and more consistent supervision of the largest and most interconnected institutions; and 3) tailoring the system of regulation to cover the full range of risks and actors in the financial system, so that risks can no longer build up completely outside of supervision and monitoring.

Many have asked whether we need a "systemic risk regulator" or a "super regulator" that can look out for new risks and immediately take action to address them or order other regulators to do so. We cannot have a system that depends on the foresight of a single institution or a single person to identify and prevent risks. That's why we have proposed that the critical role of monitoring for emerging risks and coordinating policy be vested in a Financial Services Oversight Council.

At the same time, a council of independent regulators does not have operational integrity and cannot be held accountable for actual supervision. That's why we propose an evolution in the Federal Reserve's power to provide consolidated supervision and regulation of any financial firm whose combination of size, leverage, and interconnectedness could pose a threat to financial stability if it failed. The financial crisis has demonstrated the crucial importance of having a consolidated supervisor and regulator for all "Tier 1 Financial Holding Companies," with the regulator having the authority and responsibility to regulate these firms not just to protect their individual safety and soundness but to protect the entire financial system.

This crisis has also clearly demonstrated that risks to the system can emerge from all corners of the financial markets and from any of our financial institutions. Our approach is to bring these institutions and markets into a comprehensive system, where risks are disclosed and can be monitored by regulators as necessary. Last week, Secretary Geithner testified about the need to bring all over the counter derivatives markets into a comprehensive regulatory framework. We have proposed regulatory authority for clearing, payment, and settlement systems; and strengthening the regulation of markets for securitization.

Later today we will send legislative language to the Hill that requires registration of all hedge funds and other private pools of capital over a minimum threshold in size.

Hedge funds do not appear to have been at the center of the current crisis, but de-leveraging by hedge funds contributed to the strain on financial markets and the lack of transparency contributed to market uncertainty and instability. These firms continue to present unknown risks, and that lack of transparency is no longer tenable. We need a system that's flexible enough to adapt to the emergence of other institutions that could pose a risk to the system. And we need a system that lets regulators see risks as they emerge across the financial system.

Registration and disclosure will help to protect investors from fraud or abuse, and to protect the financial system from unacceptable systemic risks building up outside prudentially supervised institutions.

To protect investors, under our proposal, hedge fund advisers will be registered with the SEC for the first time and will be required to disclose to regulators and investors more information about the characteristics of their advised hedge funds--including asset size, borrowings, off-balance sheet exposure and other matters.

To address systemic risk, under our regime, like any other firm, hedge funds that are found to be so large, leveraged, or interconnected that they pose a threat to financial stability will be regulated as Tier 1 FHCs. These firms will face appropriate prudential requirements regarding capital, liquidity, and risk management.

This legislation will require investment advisors with more than $30 million under management to register with the SEC. It will provide for both periodic reporting requirements, as well as authority for regulators to gain access to additional information to assess potential systemic risks posed by these firms.

Basic Reform of Capital, Supervision, and Resolution Authority

As Secretary Geithner has said, the three most important things to lower risk in the financial system are "capital, capital, capital." We need to make our financial system safer for failure. We cannot rely on perfect foresight--whether of regulators or firms. While some have criticized our proposals for failing to place limits on the activities of banking organizations, especially proprietary trading, our response is not to limit the activities in the system but to limit the risk that those activities can pose. Higher capital charges can insulate the system from the build-up of risk without limiting activities in the markets. That's why we have launched a review of the capital regime and have proposed raising capital standards across the board, including higher standards for financial holding companies, and even higher standards for Tier 1 Financial Holding Companies – to account for the additional risk that the largest and most interconnected firms could pose to our system.

Making the system safe for innovation means raising the buffers for financial firms against loss. It also means creating a more uniform system of regulation so that risks cannot build up without adequate regulatory oversight. For banking regulation, we propose addressing the central source of arbitrage among depository institutions by creating the National Bank Supervisor, through the consolidation of the Office of Thrift Supervision and the Office of the Comptroller of the Currency. Fragmentation and loopholes in the Bank Holding Company Act allowed firms to pursue the most lenient regulatory regime, or manipulate their corporate form to avoid tough regulation and supervision. We will end those loopholes.

Financial activity involves risk, and that we will not be able to identify all risks or prevent all future crises. We learned through painful experience that when the financial system is fragile, the failure of a large, interconnected institution can threaten the stability of the financial system. While we have a tested and effective system for banks, there is still no effective legal mechanism to resolve a non-bank financial institution or bank holding company. We have proposed to fill this gap in our legal framework with a mechanism modeled on our existing system under the FDIC.

Finally, both our financial system and this crisis have been global in scope. So our solutions have been and must continue to be global. International reforms must support our efforts at home, including strengthening the capital framework; improving oversight of global financial markets; coordinating supervision of internationally active firms; and enhancing crisis management tools. We will not wait for the international community to act before we reform at home, but nor will we be satisfied with an international race to the bottom on regulatory standards.

Conclusion

As we have discussed and debated our proposals in the weeks since its release, we have been criticized by some for going too far and by some for not going far enough. This distinction is stuck in a debate that presumes that regulation--and efficient and innovative markets--are at odds. In fact, the opposite is true. Markets rely on faith and trust. We must restore honesty and integrity to our financial system. These proposals maintain space for growth, innovation and change, but require that regulation and oversight can adapt as well. Markets require clear rules of the road, consumers rely on the trust and fair dealing of financial institutions, and regulation must be consistent, comprehensive and accountable. The President's plan lays a new foundation for financial regulation that will once again help to make our markets vital and strong.

Thank you very much.

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