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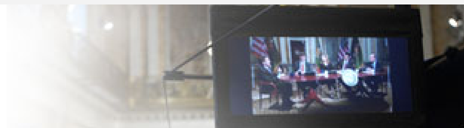

Deputy Treasury Secretary Neal S. Wolin Remarks to Financial Services Roundtable

9/24/2009

Thank you, John, for that kind introduction. Good afternoon, everyone, and thanks for the opportunity to be with you today.

This is, I think, a particularly important time for you to be gathering – and a particularly opportune moment for me to talk with you about some of the reforms that the Administration has proposed to strengthen our financial system.

One year ago tomorrow, Washington Mutual was closed by the FDIC – the largest U.S. bank failure ever. And of course, it was just over a year ago that Lehman Brothers filed for bankruptcy. In the panic that followed, our financial system nearly ground to a halt.

A swift response prevented a truly catastrophic collapse. But last September's events revealed deep weaknesses in our financial system.

It did not take long for the financial contagion to infect the real economy. When President Obama took office, America's growth rate had hit negative 6.3 percent, and monthly job losses had reached 750,000 - the worst in decades.

There are indications that we have moved back from the financial brink and are headed toward economic recovery. Important parts of the financial system are back to functioning on their own. Some of the damage to people's savings has been repaired. We have taken the first steps towards reducing the government's direct involvement in the system and reducing the risks that taxpayers are bearing.

But we cannot ignore the urgent need for action: our regulatory system is outdated and ineffective, and the weaknesses that contributed to the financial crisis persist. The progress of recovery *must not distract us* from the project of reform.

The Administration has put forward the most sweeping reform of financial regulation since the New Deal, and we are working closely with Congress to enact legislation by the end of this year.

Our goals are simple: to give responsible consumers and investors the basic protections they deserve; to lay the foundation for a safer, more stable financial system, less prone to panic and crisis; and to safeguard American taxpayers from bearing risks that ought to be borne by shareholders and creditors.

Today, I'd like to focus primarily on one of the key challenges that is at the center of the debate over regulatory reform: how to address the challenge of firms whose failure, absent reform, could threaten the stability of the financial system.

In recent decades, we've seen the significant growth of large, highly leveraged, and substantially interconnected financial firms. These firms benefited from the perception that the government could not afford to let them fail. This perception was an advantage in the market place. Creditors and investors believed that large firms could grow larger, take on more leverage, engage in riskier activity – and avoid paying the consequences should those risks turn bad. It is a classic moral hazard problem.

Of course, during the financial crisis, the federal government did stand behind these firms. That action was necessary, and it was the only option. But there is no question that, *unless we enact meaningful reforms*, the fact that the federal government intervened this past year will have made the problem worse. We take this moral hazard challenge very seriously. Our proposals for reform address it head on.

First, the biggest, most interconnected financial firms must be subject to serious, comprehensive oversight. The idea that investment banks like Bear or Lehman or other large firms like AIG could escape meaningful consolidated federal supervision should be considered unthinkable from now on.

For the largest, most interconnected financial firms – for any firm whose failure might threaten the stability of the financial system – there must be clear, inescapable, single-point regulatory accountability. The scope of that accountability must include both the parent company and all subsidiaries.

In our view, the Federal Reserve is the agency best equipped for the task of supervising the largest, most complex firms. The Fed already supervises all major U.S. commercial banking organizations on a firm-wide basis. After the changes in corporate structure over the past year, the Fed now supervises all major investment banks as well. It is the only agency with broad and deep knowledge of financial institutions and the capital markets necessary to do the job effectively.

So the first part of our approach to the moral hazard problem is clear, accountable, comprehensive supervision. The second part is tougher standards.

The days when being large and substantially interconnected could be cost-free – let alone carry implicit subsidies – should be over. The largest, most interconnected firms should face significantly higher capital and liquidity requirements.

Those prudential requirements should be set with a view to offsetting any perception that size alone carries implicit benefits or subsidies. And they should be set at levels that compel firms to internalize the cost of the risks they impose on the financial system.

Through tougher prudential regulation, we aim to give these firms a positive incentive to shrink, to reduce their leverage, their complexity, and their interconnectedness. And we aim to ensure that they have a far greater capacity to absorb losses when they make mistakes.

The third key element of our response to the moral hazard problem is to emphasize that being among the largest, most interconnected firms does *not* come with any guarantee of support in times of stress. Indeed, the presumption should be the opposite: shareholders and creditors should expect to bear the costs of failure.

That presumption needs to have real weight. That means the financial system must be able to handle the failure of any firm. In this last crisis, it clearly was not.

Leading up to the recent crisis, the shock absorbers that are critical to preserving the stability of the financial system – capital, margin, and liquidity cushions in particular – were inadequate to withstand the force of the global recession.

While the largest firms should face higher prudential requirements than other firms, standards need to be increased system-wide. We've proposed to raise capital and liquidity requirements for all banking firms and to raise capital charges on exposures between financial firms.

We've also laid out principles that we believe should guide regulators in setting capital requirements in the future. The core principle is that capital and other regulatory requirements must be designed to ensure the stability of the financial system as a whole, not just the solvency of individual institutions.

Beyond that, we've called for a greater focus on the *quality* of capital. We've called for capital requirements that are more forward-looking and reduce pro-cyclicality. We've called for explicit *liquidity* requirements. And we've called for better rules to measure risk in banks' portfolios.

We've also called for measures to strengthen financial markets and the financial market infrastructure. For example, we've proposed to strengthen supervision and regulation of critical payment, clearing, and settlement systems and to regulate comprehensively the derivatives markets.

Our plan would require all standardized derivatives to be centrally cleared and traded on an exchange or trade execution facility – substantially reducing the build-up of bilateral counterparty credit risk between our major financial firms. We would require all customized OTC derivatives to be reported to a trade repository, making the market far more transparent. We would provide for strong and consistent prudential regulation of all OTC dealers and all other major players in the OTC markets, including robust capital and initial margin requirements for derivative transactions that are not centrally cleared.

We should never again face a situation – so devastating in the case of AIG – where a virtually unregulated major player in the derivatives market can impose risks on the entire system.

Taken together, the significance of these reforms should be clear: by building up capital and liquidity buffers throughout the system, and by increasing transparency in key markets, our plan will make it easier for the system to absorb the failure of any given financial institution. The stronger the system, therefore, the clearer it will be that there is *no such thing* as an implicit government guarantee.

The final step in addressing the problem of moral hazard is to make sure that we have the capacity – as we do now for banks and thrifts – to break apart or unwind major non-bank financial firms in an orderly fashion that limits collateral damage to the system.

Bankruptcy is and will remain the primary method of resolving a non-bank financial firm. But as Lehman's collapse has showed quite starkly, there are times when the existing bankruptcy arrangements are simply not flexible enough, and bankruptcy courts not specialized enough, to deal with the insolvency of large financial institutions in times of severe crisis.

The resolution authority we have proposed gives us another alternative: it allows the government to impose losses on shareholders and creditors without exposing the system to a sudden, disorderly failure that puts everyone else at risk.

As part of our proposal, we've called for firms to prepare what some have called "living wills." We would require major financial firms to prepare and regularly update a credible plan for their rapid resolution in the event of distress. This requirement will leave us better prepared to deal with a firm's failure – and will provide another incentive for firms to simplify their organizational structures.

We believe our proposals represent a comprehensive, coordinated answer to the moral hazard challenge posed by our largest, most interconnected financial institutions: strong, accountable supervision; the imposition of costs, both to deter excessive risk and to force

firms to better protect themselves against failure; a strong, resilient, well-regulated financial system that can better absorb failure.

Together, these proposals give us a clear and credible argument that, as the President said two weeks ago in New York, "Those on Wall Street cannot resume taking risks without regard for consequences, and expect that next time, American taxpayers will be there to break their fall."

Before closing, I'd like to touch on another element of our reform proposal that I suspect is of interest to you: the Consumer Financial Protection Agency.

This financial crisis was rooted, in no small part, in a basic failure of our consumer protection regime. Millions of Americans were sold products they didn't understand and couldn't afford. No doubt, many households made irresponsible choices. But there's also no doubt that millions of Americans were misled by unclear disclosures, overly complicated contracts, or loan originators incented to close the deal without regard to the borrower's ultimate ability to pay. The result was tragic – and helped destabilize the entire financial system.

No one can look back at the events of the past two years and say that fundamental reform is unnecessary. And we cannot achieve fundamental reform within the current framework of diffused responsibility, with rule-writing and enforcement divided among a variety of supervisors with different missions and other priorities. We need structural reform.

In designing our reforms, we have been guided by at least two core principles:

First, *rule-writing and enforcement should not be separated*. We've seen all too clearly that separation of rule-writing authority from enforcement authority leads to inertia, unevenness, and erosion of standards. In addition, a rule-writing agency that lacks the benefit of hands-on supervisory experience will be far less effective. It will lack critical information about market activity and emerging problems. Just as importantly, it may not fully appreciate the burden its rules impose – making it very hard to weigh the costs and benefits of additional regulation.

Second – but closely related to the first – *supervisory authority should not be split among various regulators.* More specifically, we should not leave banks to be supervised by one agency or set of agencies and non-banks by another. If we do, standards will ultimately diverge, and market activity will migrate towards the lower standards. There must be a level playing field.

A single, independent consumer protection agency is essential to satisfy those core principles. The CFPA will have the authority to write and enforce rules to promote transparency, simplicity and fairness – for all market participants.

The CFPA will also be charged with promoting innovation, choice and fair competition. We value deeply America's vital tradition of innovation, and we reject the false choice between innovation and consumer protection. We believe that the surest way to promote innovation is to promote trust. Consumers who trust that the market is well regulated – that all financial firms will play by the rules and treat them fairly – will make the choices that best suit their needs. And successfully matching consumer needs is, in the end, the highest goal of innovation.

We are not interested in dictating business plans. We are interested in making sure that consumers have the information they need to make informed choices.

So let me just close by saying this:

There is room for honest differences on the details of the plan we have put forward – on our response to the challenge of moral hazard, on the CFPA, on many elements of our plan. It would be impossible to put forward six hundred pages of legislative language and expect full agreement from everyone.

But one year after the breakdown last September, there should be no disagreement that reform is urgently needed. It is time to bring our financial regulations into the twenty-first century. I hope that you will join with us to build a stronger, safer financial system. It's in your interest, as leaders of the financial services sector. It's in your customers' interests. And it's in America's interest.

We welcome the opportunity to continue working with you on this critical legislation.

Thank you.

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