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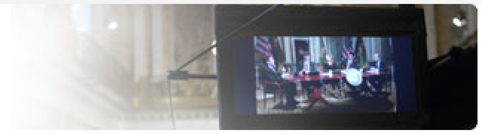

Remarks by Treasury Secretary Tim Geithner to the International Monetary Conference

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As Prepared for Delivery

Thank you, Rick, for that introduction. It’s good to be here at this conference and to have this opportunity to speak to you today about the state of global financial reform.

Nearly a year ago the President signed into law the most significant financial reforms since the Great Depression. These reforms are essential to making our system stronger and more resilient.

As we move forward, however, we face a series of consequential choices that will determine the true success of these reforms.

It has been more than three years since the start of the financial crisis that led to those reforms. And we are now in the midst of a fundamental reshaping of the financial system of the United States.

Based on the changes already achieved and those now underway, we will be able to accomplish what few people would have thought possible at the beginning of 2009. We can remake the American financial system so that it emerges from this crisis not only transformed but in much stronger shape, with the best mix of protections available in the world for investors and consumers and the best opportunities for businesses to raise capital.

If we succeed in achieving this goal, it will not be because of good fortune. It will happen as a direct result of the tough choices we made to fundamentally restructure the system as we were fighting the financial fires of 2008 and 2009. And it will be because we put in place the reforms necessary to preserve those changes, with a better balance of stability and innovation.

But as we work towards the goal of a stronger financial system, there are risks.

We have a very complicated regulatory structure with multiple agencies, with closely related and sometimes overlapping missions and roles. We must bring a more coordinated and integrated approach across these agencies to write sensible rules and to demonstrate more agility in response to an ever changing financial marketplace, in order to meet this challenge.

We live in a global financial marketplace, with other financial centers competing to attract a greater share of future financial activity and profits. As we strengthen the protections we need in the United States, we have to reduce the chance that risk just moves outside the United States. Allowing that would not just weaken the relative strength of U.S. firms and markets, it would also leave the world economy vulnerable to future crises.

The challenges of designing and enforcing new rules in this more complicated and dangerous world of finance will require a very substantial increase in the quality and scale of resources we deploy in financial oversight. If we don’t have the resources to attract, retain, and train the human talent necessary to make better regulatory judgments in the future, then we place these achievements at risk.

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I want to review the main challenges ahead of us as we work to achieve this renewal of the American financial system. But I want to start by reviewing what we have achieved to date.

The American financial system has already been changed in far-reaching ways. But the extent and significance of these changes are not well understood. Many wonder whether anything has changed, or even whether we have left the system more vulnerable.

So let me describe why we are in a much stronger position today, and where we still have a lot of work to do.

The weakest parts of the U.S. financial system – the firms that took the most risk – no longer exist or have been significantly restructured. That list includes Lehman Brothers, Bear Stearns, Merrill Lynch, Washington Mutual, Wachovia, GMAC, Countrywide, and AIG.

Of the 15 largest financial institutions in the United States before the crisis, only nine remain as independent entities.

Those that survived did so because they were able to raise capital from private investors, significantly diluting existing shareholders. We used stress tests to give the private market the ability – through unprecedented disclosure requirements and clear targets for how much capital these institutions needed – to distinguish between those institutions that needed to strengthen their capital base and those that did not.

The 19 firms that we put through that process have together increased common equity by more than $300 billion since 2008.

The average level of common equity to risk weighted assets across these institutions is now 10 percent, much higher than before the crisis. The average level of total leverage in these institutions has fallen substantially from $16 of assets for every dollar of common equity to $11.

These firms are now funded more conservatively, so that they are much less vulnerable to a loss of liquidity during a future downturn. Debt maturing in one year or less at these institutions, as a share of total liabilities, has declined dramatically to roughly 40 percent of the pre-crisis level.

Outside these institutions, the risk in the so-called “shadow banking system” – the financial firms that operated outside of the protections and constraints we imposed on banks – has fallen substantially.

Assets in the “shadow banking system” are roughly half the level seen in 2007. Funding through tri-party repurchase agreements has fallen 40 percent from its peak in 2007, and asset-backed commercial paper outstanding – which was often used to fund leveraged off-balance sheet vehicles – is a third of where it was in 2007.

The vast majority of large financial companies that received government support have repaid it, with a total return to the taxpayer from investments in banks of $12 billion dollars in profit to date. Just two years ago, hundreds of billions in losses were projected on those investments.

We now have the authority to subject all major financial institutions operating in the United States to comprehensive, consolidated limitations on risk taking. That represents a dramatic change from before the crisis, when more than half of the financial activity in the nation that was involved in “banking” from the investment banks to large finance companies, AIG, and Fannie Mae and Freddie Mac, operated outside those limits.

And the markets where firms came together – like the over-the-counter derivatives markets – will now be subject to oversight, once regulators finalize and implement new rules authorized by Dodd-Frank. We now have much stronger tools to limit the risk that one firm’s failure could cascade through markets to weaken the rest of the system.

Overall, and this is the most important test of crisis response, the U.S. financial system is now in a position to finance a growing economy and is no longer a source of risk to the recovery.

Now, it is important to recognize that even with these achievements, we have a lot of repair work still ahead of us. The housing finance system is still broken and completely dependent on the government. Small banks in many parts of the country are still under a lot of pressure. Credit is still hard to get for many small businesses and individuals.

Some argue that the U.S. financial system is too concentrated, which could promote systemic risks. But the U.S. banking system today is less concentrated than that of any other major economy. And total banking assets in the United States today are only about the size of U.S. GDP – much lower than in other developed economies.

The three largest U.S. banks account for 32 percent of total banking assets in the United States, in comparison to 46 percent for the three largest in Japan, 58 percent in Canada, 63 percent in the UK, 65 percent in France, 70 percent in Germany, 71 percent in Italy, and 76 percent in Switzerland.

And total banking assets are 461 percent of GDP in the UK, 178 percent in Germany, and 820 percent in Switzerland.

The actions we took to restructure and strengthen the financial system were extraordinary. Together with the Federal Reserve and the FDIC, we provided liquidity where it was necessary, not just to the entire banking system, but to those markets that were as critical to the broader economy. Those actions, taken together, helped prevent a second Great Depression, and have produced billions in profit to the taxpayer, on top of the profits earned from the direct investments we placed in individual institutions.

Any successful financial rescue carries with it the risk that the actions necessary to protect the economy from financial failure will create the potential for future crises, by encouraging investors to take too much risk in the future in the hope they will be protected from failure.

We were exceptionally careful to design our emergency strategy to minimize that risk of moral hazard. We let the weakest firms fail. We forced the equity holders of those that survived to absorb losses on a scale proportionate to the mistakes of their companies.

Where we had to step in and provide exceptional levels of support, we did so to diffuse the risk of catastrophic failure. We chose, in the case of Fannie and Freddie, to replace management and the boards of directors, wipe out equity holders, and wind down the institutions, a process that is still underway.

To preserve the gains we have achieved, to minimize the risk of moral hazard, and to reduce both the risk of and the damage from future crises, we have to put in place the comprehensive reforms, those legislated in the Dodd Frank Act, and those still ahead of us in the housing finance system.

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Financial reform involves far-reaching changes to investor and consumer protection, the structure of the housing finance market, resolution authority for failing firms, as well as the design of more conservative limits on risk-taking. I am going to focus my remarks today on two areas of reform that are most important to reducing systemic risk.

The central challenge in reducing future risk in financial systems has two dimensions. It requires reforms to reduce the risk of failure of large institutions and reforms to limit the damage any failure could impose on the broader economy.

This involves tougher rules to limit risk and leverage in individual institutions, but also changes in how we govern the markets where firms come together, such as the derivative markets and the funding markets. These are shock absorbers that are critical to limiting catastrophic risk in modern financial systems.

This is a complicated endeavor. It requires judgments about the costs and benefits of too much or too little capital and the tradeoffs between innovation and stability. It requires employing the power of disclosure and market discipline to reinforce the constraints and incentives we establish through regulation. It requires better supervision, because no system of rules can anticipate all sources of risk. And it requires better ways of managing the inevitable failures that will happen in competitive markets, by adapting bankruptcy type processes to handle the unique difficulties in unwinding large, leveraged financial institutions.

And because of technology and the much tighter integration of national financial systems, the challenge of reducing the risk of contagion from a financial crisis requires much more global coordination internationally than has ever been the case.

Foremost among the many challenges of reform ahead of us are those that relate to capital or leverage requirements and derivatives. It is on these two pillars that the prospect of a truly level global playing field most squarely rests.

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Let me begin by discussing the new global standards on capital.

Last year, central banks and supervisors reached agreement on the core elements of a new global capital standard, known as Basel III. As a result of this agreement, banks will have to hold substantially more capital in the form of common equity against the risks they take.

These requirements are critical to making the financial system more stable and more resilient. They were set at a level designed to allow institutions to absorb a level of losses comparable to what we faced at the peak of this crisis and still be able to operate without special government support.

The agreement was designed to allow banks to meet these heightened standards gradually, so that they can continue to perform their essential function of providing credit to households and businesses. Many institutions, and almost all the largest U.S. firms, have already reached the new minimum levels, years ahead of schedule. And the U.S. is committed to implementing the full Basel III agreement on schedule.

This agreement was the foundation of a comprehensive new capital framework, but it left open several areas to negotiation, including the size and composition of additional capital requirements to impose on the largest global institutions, how to refine the provisional liquidity requirements, and how to bring more compatibility to the risk-weighting of assets.

We are now at the point where it is important to resolve these open questions, provide clarity about the rules going forward, and allow supervisors to turn their attention to how to enforce these new requirements.

It is our hope that the central banks, supervisors, and finance ministries of the major economies working together will resolve these outstanding issues this summer.

Whether they are able to so will depend on the extent to which they can find consensus on a strong agreement with reasonable terms.

This will require decisions in three important areas.

First is the question of the size of the additional requirements to be imposed on the largest institutions, which is commonly referred to as the systemic surcharge.

There is a very strong case for requiring the largest firms, those whose failure could cause the greatest damage to the economy, to hold more capital relative to risk, than smaller institutions. I have long supported this approach. We made it a key part of our proposals for reform in the United States. And it was incorporated into law in the United States and embraced by the G-20.

The question is how much. In making this judgment, the central banks and supervisors need a balance between setting capital requirements high enough to provide strong cushions against loss but not so high to drive the re-emergence of a risky shadow banking system. They also need to look at the full impact of other reforms in the system that have the effect of reducing both the probability of failure of large institutions and the ability of the rest of the financial system to absorb or contain or diffuse those losses. Among these other reforms are the new liquidity requirements on these institutions, limits on leverage, concentration limits, activity restrictions, the forthcoming margin rules for derivatives, the stronger financial cushions being built in central counterparties, the tougher requirements on tri-party repos and securities lending.

In short, capital requirements cannot bear the full burden of protecting the system against risk, and they should be considered in the context of the reinforcement provided by these other reforms.

A second question is to distinguish between what all countries commit to require as a minimum, and what measures some countries may choose to retain the discretion to impose on top of those requirements.

In the United States, we will require the largest U.S. firms to hold an additional surcharge of common equity. We believe that a simple common equity surcharge should be applied internationally. The strength of a common equity surcharge also reduces the need for an excessive surcharge. But given the other protections available here, including our resolution authority, we do not need to impose on top of that requirement any of the three other proposed forms of additional capital – convertible, bail in, contingent capital instruments, or counter cyclical capital requirements.

And third, we need to make sure that we provide a much stronger set of protections to ensure a level playing field in the application of the new Basel III requirements and the additional systemic surcharge.

This means, among other things, a uniform and mandatory minimum leverage ratio, safeguards to ensure the consistent applications of the new risk weightings by national supervisors, sufficiently broad application of the systemic surcharge to major institutions around the world, and restrictions on the amount of discretion available to national supervisors to relax the application of these requirements to their own banks.

If we can achieve consensus on these terms, we will have a strong agreement, which will give all the major countries the confidence they need that the requirements will be implemented fairly and evenly across institutions and markets.

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These new global requirements on capital are critical to reducing the risk of failure of institutions. We need to lay the foundation for the same type of global approach to constraining risk in markets, particularly in the derivative markets.

In U.S. reforms, we are building a comprehensive framework of oversight for the over-the-counter derivatives market, which now has an estimated $600 trillion in gross exposures.

A core element of this framework is to require standardized derivatives to be centrally cleared. This replaces the exposures of an exceptionally complex web of millions of bilateral trades with a central counterparty that has strong financial safeguards and comprehensive oversight.

All derivatives contracts that are appropriate for central clearing will be cleared and traded on an exchange or other regulated trading platform. At the same time, the law makes provisions for economically essential contracts that are not suitable for central clearing – for example, trades by non-financial end users or certain complex, illiquid or otherwise highly customized derivatives.

For uncleared derivatives transactions, the Dodd-Frank Act requires new margin standards that reflect the nature and risk of these contracts. Regulators have recently proposed rules to implement this requirement. These margin requirements are critical to promoting the safety and soundness of the dealers and lowering the risk of the financial system. Imposing appropriate margin requirements on uncleared swaps will also help create incentives for market participants to use centralized clearing and standardized contracts so that they do not needlessly externalize risks to the financial system by avoiding central clearing. New margin requirements will also mitigate the increased risks presented by derivatives that are appropriately executed outside of central clearing, and therefore do not benefit from the protections of a central counterparty.

In practice, the combination of central clearing for many transactions and margin requirements for most uncleared transactions, in conjunction with trading on exchanges or other regulated platforms, will not only reduce risk in the system, but also encourage increased standardization of derivatives, and thus additional central clearing and exchange trading. Central clearing and trading, in turn, along with increased post-trade transparency mandated by Dodd-Frank, will provide increased market liquidity, tighten spreads, reduce transaction costs, and facilitate the evolution of a more transparent market.

The United States has taken an important leadership role in comprehensive reform of the over-the-counter derivatives market. Alignment with Europe and Asia is essential.

The focus of that remaining work towards alignment with our European counterparts lies in a few key areas: scope of standardized derivatives contracts, central clearing and mandatory trading of standardized derivatives contracts, fair and open access to qualified participants for central counterparties of swaps, electronic trading platforms, reporting to data repositories, the scope of any exceptions or exemptions – for example, end-user exemptions and intra-group exemptions – and, finally, capital and margin requirements.

Likewise, progress in Asia on derivatives is essential. We urge our Asian counterparts to meet G-20 commitments to central clearing, mandatory trading, and reporting of standardized over-the-counter derivatives by the end of 2012. Recently, Deputy Treasury Secretary Neal Wolin traveled to Asia to discuss these issues, as part of a series of efforts to make progress on derivatives reforms in the region. He will be making that trip again.

Now, as we work with our international counterparts on this range of issues, we need to develop a global margin standard.

Just as we have global minimum standards for bank capital – expressed in a tangible international agreement – we need global minimum standards for margins on uncleared derivatives trades.

Without international consensus, the broader cause of central clearing will be undermined. Risk in derivatives will become concentrated in those jurisdictions with the least oversight. This is a recipe for another crisis.

A global approach to margin will help prevent regulatory arbitrage and a “race to the bottom.” It will make our global financial system safer and stronger.

Both banking and market regulators are now in the process of laying the groundwork to set an international effort in motion, by asking the FSB and the international standard setting bodies to undertake analysis and recommendations. The United States will take a leading role in this effort, and I expect there will be support for it in Europe and in the G-20 more broadly.

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In the meantime, we still have work to do at home. Regulators have been busy proposing rules to implement the Dodd-Frank Act, and many of these rules still need to be finalized. To build a strong regulatory framework that can serve as a model for international efforts, it is critical that the rules put in place by these regulators are as consistent as possible.

The regulators are independent agencies, with independent mandates. Where Congress has given them the room to adopt common approaches, they need to do so, both so that we reduce the chance of risk shifting among institutions subject to their different jurisdictions, but also so that we improve the chances of promoting a uniform global approach that does not damage U.S. firms.

Congress decided in designing our financial reforms to preserve a system of specialized, functional supervision, with different regulators responsible for consumer protection, for investor protection and market integrity, for supervision of banks, and for deposit insurance and bank resolution. And Congress brought these regulators together in a Council with a mandate to encourage a more system-wide and coordinated approach to critical regulatory questions that affect the financial system as a whole.

This framework has a lot of strength, but it adds to the complexity of designing reforms that work across institutions and markets. Small differences in approach will create opportunities for risk to move around the system and to hide in the dark, which is part of what made our crisis so severe.

I am very encouraged by the first year of experience in seeing these regulators work more closely together. It gets harder from here, and even more important that we achieve a common approach.

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I want to conclude with a few comments on the third of the challenges I started with: the challenge of strengthening the resources we need to make these reforms work.

In the years before this crisis, Washington allowed the financial system to outgrow the framework of protections that we put in place after the Great Depression and refined in the decades that followed. We allowed the emergence of a parallel or “shadow” financial system outside of the constraints we place on banks. The rules on banks fell behind the pace of innovation in markets. The resources in terms of numbers of bank examiners and enforcement officials and their expertise fell behind the growth in our markets and the increased complexity of the system.

The success of the Dodd Frank Act will depend on a sustained effort to improve the level of expertise in the regulators charged with oversight and to ensure there are enough “cops on the street” that can look into the seams and shadows of the financial system and more effectively deter fraud and manipulation.

This is not a new challenge, but we face two new risks in addressing it. One is the effort by politicians and groups that oppose financial reform to starve the regulatory agencies of the resources they need to carry out their new responsibilities. The second is to use the confirmation process to block appointments.

Those in the U.S. financial community who are supporting these efforts to block resources and appointments are looking for leverage over the rules still being written. There is a long tradition of similar efforts. They will not be successful in undermining the core elements of reform, but they will risk causing a different type of damage.

Over time, they will make it less likely that there will be enough capable people in the regulatory bodies to bring the care and judgment necessary for the new rules to work. The firms that will suffer most from weak regulators are the strongest and best managed firms, for they will find themselves spending more time on compliance and will be potentially placed at a greater disadvantage with respect to their international competitors. And they will create the conditions again for a situation in which the weak and poorly-managed risk bringing down the financial system again. We can’t allow loopholes, gaps, and weaknesses to take hold and undermine the fundamental strength of our reforms. We’ve been down that road before, and it led us to the edge of the abyss. We won’t allow that to happen again.

Those of you here today who are leaders of the major U.S. financial institutions should be champions, not opponents of getting strong capable people to lead and staff the oversight bodies.

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We are committed to building a more level playing field internationally, as we move ahead with reforms in the United States.

We don’t want to see another race to the bottom around the world. As we act to contain risk in the U.S., we want to minimize the chances that it simply moves to other markets around the world.

The United Kingdom's experiment in a strategy of "light touch" regulation to attract business to London away from New York and Frankfurt ended tragically. That should be a cautionary note for other countries deciding whether to try to take advantage of the rise in standards in the United States.

But it is important to note that the strength of the United States financial system in the decades that followed the Great Depression was that we had the highest standards for disclosure and investor protection, we had the strongest protections for depositors and against money laundering, and we had the best exchanges. We did not lower our sights to match the more limited ambitions of others. We knew we would be more vulnerable if we did.

So we will do what we need to do to make the United States financial system stronger. We will do so carefully. And as we do it, we will bring the world with us.