

The Agenda for Financial Reform

Remarks by
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Good afternoon ladies and gentlemen, I and my fellow panelists have been asked to comment on the prospects for financial reform in the wake of the financial crisis. To put it mildly, this is a daunting task in which the devil is very much in the details.

- As an example, the financial reform bill that passed the US House of Representatives shortly before Christmas is more than 1000 pages in length.
- Much of what I have to say will be based on developments in the US but such developments have much in common with events internationally.

At the risk of considerable over simplification, I believe it is fair to say that the reform agenda has seven major elements as follows

First: in the US and in other jurisdictions efforts are underway to create a so-called "systemic regulator." While many of the details have yet to be worked out, I believe that this effort should incorporate the following critical features.

- The systemic regulator should be the consolidated prudential supervisor for all systemically important institutions.
- The systemic regulator must look beyond the condition of individual institutions in order to better anticipate potential sources of economic and financial contagion risk. Anticipating future sources of contagion is not easy; taking steps to mitigate contagion is even more difficult, but neither is impossible.
- The systemic regulator must also play a role in helping the authorities more generally to identify symptoms of emerging asset price bubbles. I know how difficult this can be and I know very well how extremely difficult it is to muster policy responses to emerging bubbles. On the other hand, there are circumstances in which even a modest tilt in monetary and/or supervisory policy may be justified in the face of emerging conditions along the lines of events in the housing market in the United States over a period of several years before the onset of the crisis.

- Given these observations, it will come as no surprise when I say that this discussion of the mission of the systemic regulator leads me to the conclusion that Central Banks generally – and the Federal Reserve particularly – must play a major role in efforts to better anticipate future sources of contagion and to master the detailed insight into financial markets and instruments that are so important to efforts to limit the risk of contagion.

Second; substantially higher and more rigorous regulatory capital and liquidity standards should be phased in over the next couple of years.

- Clearly, one of the important lessons of the crisis is that capital adequacy and liquidity adequacy must be managed and supervised as an integrated discipline.
- Even a casual reading of the consultative paper released by the Basel Committee shortly before Christmas leaves little doubt as to the intention of the authorities to work toward a much more conservative framework of capital and liquidity adequacy which, among other things, is likely to result in a universal leverage ratio standard and notably higher capital charges for certain classes of high-risk trading activities.

Third; substantial enhancements in risk monitoring and risk management and their prudential oversight are needed.

- I have long believed that there is a basic distinction between risk monitoring and risk management. Specifically, risk monitoring is a matter of getting the right information to the right people at the right time while risk management relates to how that information is used to manage patterns of market, credit, counterparty and operational risk. Much has been said and written about failures in risk management but even casual observations tend to suggest that failures in risk monitoring contributed importantly to the failures in risk management. In fact, I would go one step further and suggest that failures in risk monitoring will – inevitably – lead to failures in risk management.

- The effectiveness of risk monitoring and risk management rests on many factors but one such factor of critical importance is absolute independence of control functions and personnel in such areas as risk management, credit, controllers and compliance.
 - o As an extension of that concept of independence I also believe that a rigorous framework of price verification rooted largely in mark-to-market accounting serves a vital role as an "early warning" signal of emerging asset quality problems.

Fourth; an essential ingredient in coming to grips with "Too Big to fail" relates to the ability of supervisors and market participants to make "prompt corrective action" a reality not a slogan.

- For this to happen, the discipline of (1) stress tests; (2) so-called "reverse stress tests;" and (3) rigorous scenario analysis of truly extreme contingencies (so-called "Living Wills") must become part of the risk management routine at individual institutions. Further, that routine should be subject to ongoing oversight by prudential supervisors. To the uninformed, this may sound like a straightforward undertaking but in fact it is an enormously complex endeavor which relies far more on informed judgment by senior managers and senior supervisors than it does on models and metrics.

Fifth; we must continue to redouble efforts to better insure that weaknesses in financial infrastructure with systemic risk implications are rooted out both domestically and internationally.

- Thankfully, substantial progress had been made in this area even before the crisis.
- Having said that, much remains to be done. As I speak, for example, we are still in the early stages of clearance and settlement of OTC derivatives – especially credit defaults swaps – through centralized counterparty clearing facilities (CCPs). As these arrangements mature, I believe that the

operational and financial integrity of such CCPs must be virtually failsafe. For example, such facilities should be subject to direct oversight by central banks and the financial integrity of such facilities should be such that they could withstand the default on the same day of their two largest members.

- In the US in particular, curtailing systemic risk in the OTC derivatives markets is very much a part of the legislative agenda. In these circumstances, there are some observers who take the position that all OTC derivatives trades should be standardized and all such trades should be exchange traded and cleared and settled through CCPs. In my judgment and experience, that extreme position is neither necessary nor desirable. Customized trades play a very necessary role and the use of the depositories or warehouses – together with strong capital and collateral standards – can achieve essentially the same benefits in terms of systemic risk reduction that grow out of CCP clearing and settlement for standardized trades.

Sixth: we need a flexible and effective framework of “Enhanced Resolution Authority” to facilitate the expeditious and orderly wind-down of large, complex and highly interconnected financial institutions.

- Reduced to its basics, the concept of Enhanced Resolution Authority is one that contemplates a statutory and regulatory framework in which an authorized governmental body (or bodies) could take control of a large and complex financial institution that is experiencing life threatening problems in order to organize the orderly wind-down of that institution such that shareholders are likely to be wiped out, boards and senior managers are dismissed and most classes of creditors are at risk.

The practicalities of effective resolution of such institutions are of staggering proportions. Indeed, there is a risk – however small – that an ill-conceived or executed approach to enhanced resolution could create heightened uncertainty and instability. My short list of

"guiding principles" can help to ensure that Enhanced Resolution Authority achieves its objectives includes the following:

First, the authorizing legislation and regulation must not be so rigid as to tie the hands of the government bodies that will administer them.

Second; the responsibility for Enhanced Resolution Authority should not be vested in any single government body.

Third, to the maximum extent possible, this authority should be administered using the open institution approach which probably means the troubled institution should – for a limited period of time – be placed into some form of conservatorship allowing it to continue to perform and meet its contractual obligations as part of the wind-down exercise.

Fourth, to the maximum extent possible, the rights of creditors and existing contractual rights and obligations need to be protected.

Fifth, the effectiveness of Enhanced Resolution Authority presupposes that "prompt corrective action" by supervisory authorities is well established and is working effectively.

Finally, the orderly wind-down of any large institution is a highly complex endeavor that will take patience, skill and effective communication and collaboration with creditors, counterparties and other parties.

In the United States, new legislation is necessary to achieve Enhanced Resolution Authority and provisions toward this end are contained in the bill passed by the House in late December and are expected to be part of the bill now emerging in the Senate. However, it is far from clear what the final legislation will look like and there is some risk that particular features of new law (such as mandated haircuts for secured creditors) could be a source of considerable uncertainty and elevated financing cost in the financial market place.

The goal, of course, is the expedited and orderly wind-down of large and complex financial institutions. While the goal is appropriate it is important to keep in mind that rarely – if ever – have we witnessed the successful wind-down of a very large and complex financial institution and none of us are able to anticipate the exact circumstances in which Enhanced Resolution Authority will have to be exercised when (not if) we next confront a failing systemically important institution. If ever there was a case for flexibility and care, this is it.

The seventh and last point I would like to raise takes the form of a reminder; namely, we should all keep in mind that even though the darkest days of the crisis occurred more than a year ago, the legacy of the crisis in terms of swollen central bank balance sheets, large governmental capital interventions in both financial and non-financial institutions and virtually unprecedented budgetary deficits in the US (and elsewhere) remain. Winding down these extraordinary, but necessary, interventions will not be easy, especially in the case of the US budget deficit and in circumstances in which most observers anticipate a modest recovery in economic activity in the industrial countries. These legacy issues forcefully make the point that completing the agenda for financial reform is truly urgent since sustaining growth and job creation depend importantly on a strong and stable system of financial intermediation.

Thank you.