

THE FINANCIAL CRISIS AND THE REGULATORY ENVIRONMENT

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I am delighted to be here today.

Obviously, we have experienced several shocks in this country, from housing to the financial implosion to the commodity price shocks and now a dramatic loss of confidence in the institutions of credit.

The Federal Reserve has been involved in this from the start. We have engaged in a new scope of broadening our lending facilities and are now lending outside of the immediate commercial banking area. Within the banking area we have expanded our primary credit. Through our Term Auction Facility, we're lending well over \$140 billion. Our primary dealer facility has been involved with well over \$70 billion of lending. Our foreign exchange swaps have been more than \$600 billion. Our money market mutual fund liquidity provision has more than \$140 billion, and we are involved in a commercial paper facility as well. In the meantime, we have lowered our fed funds rate from 5¼ to 1½ percent. Each of these steps has provided important liquidity within the system as we have tried to work through this problem.

This is in addition to the other bailouts, starting with Bear Sterns and continuing through the most recent \$700 billion initiative, which is daunting to say the least.

Now, the financial industry itself has to step up. While the leadership and actions of the Federal Reserve and the Treasury are necessary and of utmost importance, we cannot do it alone. We need our 21st century J.P. Morgan, who also led Wall Street and the financial sector when the nation was in a financial crisis 100 years ago. A very important part of this is willingness to cooperate and trust one another. Rather than every man and woman for themselves, I think the financial industry has to come together and say, "How can we handle this?" If it doesn't, credit won't be released no matter what steps policymakers might take. We have to get beyond the fear and work forward. If the Federal Reserve provides liquidity and the Treasury provides significant capital, then the financial industry can and should step up to the challenges of making loans to credit-worthy borrowers.

The regulatory bodies, the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, along with the other regulatory agencies around the world, also have to fill their role in working

with the industry, not overreacting, but at the same time pushing us toward solutions. That will be one of our major challenges.

If the International Monetary Fund is correct, the estimated financial losses for U.S. originated credits are a little less than \$1.5 trillion, more than half of that has been charged off and some of that has been recapitalized already. So the proposal that you heard described here today, I think, has the wherewithal to address the remaining capital needs of the industry

We have to show the confidence that the plan will work and then begin to act accordingly if we are going to move through this crisis. The fact is that we have been in crises before, we've managed through them and we will do it once again. I was involved in supervision and regulation during the banking crisis in the 1980s. During those trying times it seemed every bit as tense as the crisis we have now. But steps were taken, plans were implemented, we got through it and we were wiser for it.

I also think it's important that although problems seem to overwhelm us that we stop at this point and look into the future, knowing this crisis will pass. Central banks are charged with being concerned with the long run, and we need to think about resolution and some of the reforms that will be needed as we go forward.

As we begin this process we must be careful not to misdiagnose the problem. In saying that, I would also note that, despite some people's views, the supervisory structure is not the cause of this crisis. There is almost an infinite variety of regulatory structures, from the multisupervisory structure of the United States to the Financial Services Authority in Great Britain. No structure seems to have done particularly better or worse than another in preventing these imbalances, the resulting problems and panics.

The hard truth is the crisis was seen coming and the warnings were mostly ignored during the boom. The regulators also failed to say "no" or insist on contingency plans during that boom time. In addition, we need to introduce better countercyclical safeguards to better assure we do not face this again in the future. I am aware that when times are good it is very difficult to impose constraints on the institutions that are enjoying the good times.

One of the debates that will come out of this debacle, for example, is principles-based supervision or rules-based supervision. Based on my own experiences, I am very

much supportive of a rules-based program. Principles-based solutions usually become vague, they're subject to volumes of regulatory interpretations and they become more procyclical than countercyclical.

I would suggest that any approach we might one day adopt must have three elements to it. The rules need to be relatively simple, understandable and enforceable. The more complexity there is to a set of principles, the less likely they are to succeed.

For example, one of our major challenges will be the Basel capital proposal. Risk-based capital, as we have attempted to build it, has become increasingly complex and difficult to understand and has provided too little information to the broad public.

In contrast, a simpler, although hardly foolproof approach is the use of the leverage ratio as a measure of overall risk to an institution. During this crisis, the leverage ratio has been the capital measure of choice, more often than any other capital measures. If you looked at the investment banks, the ratios average somewhere around 30-to-1. Everyone understands that. When you look at banks, it is around 12-to-1, sometimes as high as 15-to-1. These ratios are straightforward and simple. If we set a range of standards around that, I think they would be more enforceable. I don't recall a single discussion of substance over the last several months about risk-based capital, and that is a hard truth.

When you have boundaries that are clear, that set reasonable limits within which an institution must operate and they are enforceable by the primary supervisor, I think it becomes more countercyclical. We know it will not eliminate the crisis, but it will mitigate the damage.

Finally, let me end by suggesting a number of other issues that this crisis raises that we will need to think about as we go forward:

- As the consolidations continue, we need to address the rising levels of concentration of financial resources among a financial oligarchy that will wield vast powers in the future.
- The degree to which we accept too big to fail. If we do accept that, then the premiums that should be charged these favored institutions for that status.
- The oversight required of the entire industry of hedge and equity funds will have to be addressed as this crisis proceeds.

- The appropriate degree to which the central banks of the world should extend their lending facilities to staunch financial crisis in the future.
- The level of guarantee the government might give to the assets of individuals who place them in trust of private financial managers and institutions of any size and import. That is extremely important as we work through this crisis and are making decisions today.
- The unintended consequences should be looked at in terms of moral hazard that are introduced by extending government safety nets now globally.
- We also need a framework for how we resolve these issues. We need to put it in place in advance of the next crisis so we can find a systematic way in the future.

There is much to do. We must use the tools we have to navigate these difficult waters. The Treasury's most recent capital program will be important to moving forward and how we implement it will determine its success.

I'm optimistic we'll work through this crisis. Then, we need to turn to addressing the very thorny issues this crisis has set in motion.

Thank you.