Remarks by
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to the
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The topic for this session is "Regulating the Frontiers of Competition in a Growing Economy." The agenda states that: "As the economic histories of North America and Europe indicate, major financial crises can occur when regulators cannot keep up with the changes and innovations taking place in the industry. What lessons from regulatory developments elsewhere in the world are applicable to China today, and what challenges loom in the horizon?"

This is a timely and important subject. Clearly, there are many challenges facing all of us in today's financial environment. Globalization, financial innovation, technological change, heightened competition, rapidly growing bank size and complexity make this a very challenging world for bankers and bank regulators.

There are three periods of time I would like to discuss. The first period is the 1930s, when the U.S. went through its Great Depression. The second is the 1980s and the early 1990s timeframe, when the U.S. experienced its savings and loan crisis. Finally, I will talk about this year given the current problems in the markets for subprime mortgages, asset backed commercial paper and structured investment vehicles. While every situation is different, each of these three periods has relevance with respect to the challenges facing China today and in the years ahead.

Overview: Financial Stability and Market Discipline

First, by way of background, I would like to talk about two important objectives that all countries and their financial regulators should try to achieve in order to maintain economic growth over the long term.

The first objective is to maintain financial stability. Financial stability is critical for a smoothly functioning economic system. As we know, when there is disruption and uncertainty markets do not perform well. Sometimes the disruption can occur suddenly and in a fairly dramatic way.

The second objective is to preserve market discipline. Markets perform much better when individuals are held accountable for their own economic decisions. Without market discipline, there is a misallocation of resources and excessive risk-taking.

Finding the appropriate balance between financial stability and market discipline is difficult. Sophisticated market participants should have the incentive to understand, monitor and help control risks in our financial systems. However, allowing market participants to suffer the consequence of their actions can often lead to financial instability. Yet preserving financial stability can often mean protecting individual decision-makers from the consequences of their actions.

The 1930s: The Great Depression

With that as background, I would like to start by discussing the U.S. experience during the 1930s. This was a period during which there was no shortage of market discipline and individual accountability, but there were not enough mechanisms in place to preserve financial stability. Prior to the 1930s, financial markets encountered periods of instability and crisis. The economic depression of the 1930s was the worst of these episodes. The stock market, which had increased by 240 percent during the 1920s, suddenly crashed losing 87 percent of its value in less than three years. Gross Domestic Product declined by 27 percent, and unemployment rose from 3 percent to 25 percent.

During the 1930s, market participants were clearly held accountable for their own economic actions, even though it would be hard to expect even the most financially sophisticated individuals to be able to make good economic decisions at that time. Moreover, because there was no social safety net many people suffered severe economic hardships.

From this experience, the U.S. learned that steps needed to be taken to provide a social safety net to protect the general public from dramatic declines in their economic well-being. Unemployment benefits were introduced to provide temporary sources of income when individuals lost their jobs. The Social Security System was put in place to provide basic levels of retirement income. These and other steps were taken to insulate the general public from catastrophic harm that could otherwise result from sudden changes in economic conditions or their personal financial condition.

In the 1930s, the people had lost confidence in the U.S. financial system. There were widespread bank deposit runs causing the operations at hundreds of banks to be suspended. Some of these banks were insolvent and had to be closed, but the average bank customer could not distinguish between solvent and insolvent banks. As a result during times of distress all banks were susceptible to runs.

In 1933, the U.S. President Franklin Roosevelt, said that, "There is an element of our financial system more important than currency, more important than gold, and that is the confidence of the people." It was at this time that the federal deposit insurance system

was created in the U.S. With the introduction of a credible deposit insurance system, a mechanism was put in place to restore public confidence in the financial system. The bank runs stopped and the economy eventually recovered.

An important lesson we learned from this, our largest financial and economic crisis, was that a deposit insurance system can contribute in a significant way to preserving public confidence and financial stability. Insured depositors do not have to try to determine the financial condition of their bank. This reduces the likelihood of bank runs. Deposit insurance also is an important element of the social safety net for the average family. It allows the general public to know that their money is safe. In the 1930s, it was too much to expect the average person to be financially sophisticated enough to know which banks were safe and which were not. That is even more the case in today's increasingly complex banking world.

With the introduction of these important safeguards to provide individuals with a social safety net and to better preserve financial stability, the pendulum moved toward a healthier balance between maintaining market discipline and preserving financial stability. The Great Depression taught us what I believe is still our most important financial regulatory lesson: the federal government must provide the general public with a financial safety net during times of severe economic distress. Not only does a financial safety net protect individuals from catastrophic harm, it moderates the overall impact of financial and economic downturns. Because of this financial safety net, the Great Depression remains the worst financial and economic downturn in U.S. history.

The 1980s and Early 1990s: The Savings and Loan Crisis

I'd like to turn now to the 1980s and the early 1990s. During this period the pendulum in the U.S. swung too far in the other direction. Public confidence was maintained and financial stability was preserved, even when hundreds of banks and savings and loan institutions were being closed. However, the government and banking regulators were too slow in reacting effectively and there was insufficient market discipline. As a result, the U.S. experienced its savings and loan crisis, the most significant period of financial and economic distress we have experienced since the Great Depression.

The primary focus of savings and loan institutions, or S&Ls, was home mortgage lending. S&Ls borrow money on a short-term basis through their deposit-taking activities, and lend that money on a long-term basis for home mortgages. At that time most of these mortgages were for 30-year terms at fixed rates of interest. This created a maturity mismatch between their assets and liabilities that made S&Ls vulnerable to rising in interest rates. In the early 1980s, interest rates in the U.S. rose dramatically, as the Federal Reserve sought to, and eventually did, bring inflation under control. However, a side effect of these actions was that many S&Ls became insolvent.

Even though they were insolvent, they were not closed, nor were their activities carefully regulated and supervised. At first Congress and the regulators lowered bank capital requirements and eased bank accounting standards, hoping this would buy enough time

for interest rates to fall allowing most of these S&Ls and, to a lesser extent, banks to regain their solvency. Unfortunately, they did not. Instead, lax regulation allowed the owners of S&Ls to take on greater risk, creating a moral hazard problem with significant negative consequences.

This period of history demonstrates the flip side of the problem that occurred in the 1930s. The owners of these insolvent S&Ls realized they had little to lose by taking dramatically greater risks. They offered higher interest rates for insured deposits than their better managed, more conservative competitors. Insured depositors knew their money was protected even if their S&L was insolvent. As a result, many people moved their money from healthy banks into insolvent S&Ls to earn a higher rate of return. That new money, deposits gathered through brokers, was then used by S&Ls to fund high-risk lending activities, primarily speculative real estate ventures.

By the mid-1980s, real estate markets in the U.S. had collapsed, the insolvent institutions now were much larger, and their losses were much greater than in the early 1980s. When these insolvent institutions were finally resolved, the cost to the government was much higher than it would have been if earlier action had been taken. By allowing insolvent institutions to remain open, and by not subjecting them to stronger regulatory and supervisory controls, financial resources were misallocated on a fairly large scale resulting in a great deal of waste, poorer overall economic performance and eventually a significant redistribution of wealth between winners and losers in this process.

To give you a sense of the magnitude of the problem, during a 15-year period between 1980 and 1994 over 2,900 banks and savings-and-loan institutions with nearly $1 trillion in assets were resolved. The total cost to the government and to the deposit insurance funds for these bank and S&L resolutions was almost $200 billion.

In 1991, a law was enacted in the U.S. that mandates that prompt corrective actions be taken when bank capital falls below certain prescribed levels. These actions include restrictions on the use of brokered deposits, limits on asset growth, restrictions on the payment of dividends, and timely closure if bank capital drops below 2 percent of total assets. The reason for this provision in the law was to better ensure that banks remained well capitalized and that bank supervisors took timely enforcement actions when problems emerged.

That same law requires that the FDIC implement the least-costly transaction when a bank is resolved unless there is a determination by the FDIC, the Federal Reserve and the Secretary of the Treasury, who must consult with the President, that the least-costly transaction will create systemic risk. No large banks have failed and no systemic risk determinations have been made since that law was enacted. The reason for this provision in the law was that Congress wanted to instill more market discipline in the U.S. banking system by making it more likely that uninsured creditors and shareholders will not be protected against losses when a bank becomes insolvent and is resolved. Since this law was enacted, the FDIC has implemented the least costly resolution in

every bank failure, which means that uninsured creditors generally have not been protected against losses in failing bank situations.

These legislative changes shifted the pendulum between financial stability and market discipline once again, this time in order to restore a greater level of market discipline into the process.

2007: Subprime Mortgages and the Credit Crunch

Let me now shift to the financial problems that have occurred this year.

Subprime Mortgages

The first issue relates to the problems in the subprime mortgage market. Unlike the S&Ls of the 1980s, many institutions that provide home purchase loans today do not keep these mortgages on their own books. Instead of an originate-and-hold strategy, many mortgage lenders have an originate-and–sell strategy.

The benefit of this for individual institutions is the opportunity to lower their overall risk through increased diversification. One downside that has become increasingly clear in recent months is that overall risk levels in the global economy may be higher as loan originators have had less incentive to adopt prudent underwriting standards.

This was clearly the case in the subprime mortgage market where many loans were originated at 100 percent loan-to-value ratios, with starter interest rates that would increase significantly after the first couple of years. The mortgage debt-to-income levels for these borrowers was in many cases 50 percent or higher at the initial interest rate . In addition, many times the lender did not verify the borrower's income. These loans may have worked out if home prices kept rising. However, they were destined to fail once home prices started to fall, and the monthly mortgage payments were adjusted upward to reflect the higher long-term rates.

Ready access to funding from the secondary market helped the subprime mortgage share of all loan originations more than double from 2003 to 2005, from about 8 percent to 20 percent. As of year-end 2006, the total balance of subprime mortgages was estimated to be $1.24 trillion – about 12 percent of all mortgages outstanding. However, by mid-2007 payments on about 15 percent of all subprime mortgages were past due by at least 30 days. As mortgage rates reset to higher rates over the next couple of years on an estimated $300 billion in subprime mortgages, many borrowers will face the prospect of foreclosure.

One of the lessons we have learned from this experience is that more attention needs to be paid to financial activities occurring off banks' balance sheets. Bank regulators generally focus on on-balance-sheet activities. If a bank originates a poorly underwritten loan and sells it, bank examiners have not focused on it during a bank examination because there is no expectation that it will impact the bank's financial performance.

The second lesson is that more needs to be done to protect the general public against unfair and deceptive lending practices. Many subprime borrowers entered into mortgage loan agreements they did not fully understand. In many cases these borrowers are finding themselves with a mortgage they cannot repay. As more subprime borrowers find themselves facing significant financial stress, the prospects for the performance of the securities that are made up of these subprime mortgage loans also become less certain. It is in this kind of situation that there is a clear intersection between bank safety-and-soundness issues and consumer protection issues.

Asset Backed Commercial Paper and Structured Investment Vehicles

A second issue that has emerged this year is related to a type of financial activity that is taking place in the Asset Backed Commercial Paper and Structured Investment Vehicle market. In most cases these vehicles are not owned by banks. But banks receive fees for sponsoring them. SIVs engage in the same type of short-term borrowing and long-term lending as banks, but they do so without the same type of capital standards and supervisory requirements. Generally, these structures were established off banks' balance sheets specifically to reduce the amount of regulatory capital that an institution was required to hold while still maintaining very profitable and important business relationships. These structures seem to work if they are only doing business with the more sophisticated market participants and not the general public, and if banks are not responsible for their financial well-being. However, as we are seeing, the ABCP and SIV issues are closely related to the problems in the subprime market, which does affect the general public and, due to reputational risk or other factors, banks are assuming some responsibility for these investment vehicles. That raises questions for financial regulators regarding what safeguards may be appropriate in governing these relationships. Even the new Basel II framework, with its emphasis on aligning capital more closely with risk, may not fully address the issues associated with these highly complex off-balance-sheet structures. While Basel II assigns some amount of capital for short-term liquidity facilities that banks provide to conduits, it does not charge capital in arrangements where the bank has no such contractual obligation to provide liquidity.

Many of the problems stemming from the ABCP and SIV fallout are attributed to the lack of transparency associated with these off-balance-sheet financing vehicles. In the past, investors were generally comfortable with funding these structures because the securities were often rated AAA or A-1. That is the gold standard in rating agency parlance. In some cases, investors relied heavily upon those ratings instead of performing their own due diligence on the structure and asset composition of these vehicles. When the concerns with subprime mortgages began to spread across the world, investors became nervous about whether their ABCP and SIV investments were exposed to subprime risk. In the absence of clear and transparent disclosures, many investors refused to continue to roll over the paper, which forced the sponsoring banks to step in and buy the paper in order to avoid what would essentially be a "run" on the SIV.

The industry and the regulators are still assessing what went wrong in the ABCP and SIV markets. Some have indicated that the vehicles were poorly structured. That is probably the case at least with some SIVs, where there is serious concern that if these vehicles were forced to unwind, they would dump billions of dollars in hard-to-value mortgage securities on an already uncertain market. Others believe that greater transparency is needed. The Basel II framework enhances disclosures, but more may be needed in the area of structured finance to provide order to this market.

These developments illustrate the ongoing challenge of assessing risk in our regulatory capital rules. The Basel II Advanced Approach is a prime example of how regulators strive to develop risk sensitive capital requirements. With its reliance on banks' internal models and agency credit ratings, this approach is ambitious, but unproven. Our U.S. implementation of Basel II reflects includes important safeguards to ensure both a strong base of capital and the opportunity to make corrections if the new rules have unintended consequences.

Deposit Insurance

In September, a third issue arose. Hundreds of depositors lined up to withdraw their money from Northern Rock, a mortgage lender in the United Kingdom (U.K.). Northern Rock is a $200 billion deposit-taking institution. To stop the run U.K. regulators announced that all of the bank's depositors would be protected against loss. Bank regulators then announced that depositors in Northern Rock, and depositors in all other banks in the U.K. would be protected against any loss.

What happened? Bank deposit insurance presumably eliminates the need for depositors to worry about the safety of their insured deposits. What is it about the U.K. financial regulatory system that led to their first bank run in 140 years?

Financial regulators in the U.K. are reviewing several issues. One area of review related to the deposit insurance system. The U.K. has already raised their deposit insurance coverage levels. In order to better prevent bank runs, full coverage levels should be high enough to ensure that a large majority of depositors get all of their money back when a bank fails. In the U.K., the deposit insurance system only guaranteed all deposits up to about $4,000 (U.S.). That was not high enough. The full coverage level is now around $70,000 (U.S.). The argument is often made that high deposit insurance coverage levels reduce market discipline. However, the reality is that no country will allow depositors to lose all of their money in a bank failure. It is too disruptive. A deposit insurance system that completely protects most depositors will promote financial stability as will full government guarantees for all depositors. However, full government guarantees, whether they are implicit or explicit, provide less market discipline than do deposit insurance programs where the larger, more sophisticated depositors remain uninsured and subject to the risk of some losses.

Another area under review in the U.K. is the speed with which insured depositors get their money back when a bank fails. It is extremely important that when a bank is

resolved that insured depositors get their money back in a timely manner. Most people need access to their bank deposits to meet their day-to-day living expenses. The inconvenience associated with long delays in obtaining access to their money also provides an incentive for insured depositors to withdraw their money from banks perceived to be in trouble.

Under U.K. law, bank closings are to be handled through the regular bankruptcy process. This can lead to delays of several months before insured depositors receive access to their funds. In the U.S., bank closings are handled outside of the normal bankruptcy process. Our experience suggests to us that normal bankruptcy procedures should not be applied to banks. Having a special receivership process for banks helps to expedite the process and minimize disruption and inconvenience to bank customers.

As banks grow larger, more complex and have increased cross-border activities the failure resolution process grows in complexity and importance. While it may be too disruptive to financial stability to disrupt the activities of large banks there are ways to instill market discipline without creating systemic risk. These are discussions that all countries and their financial regulators should engage in as banks become larger and the world's financial markets become more integrated.

Conclusion

In conclusion, I'd like to come back to the question raised at the outset: What can financial regulators do to try to stay ahead of market developments and prevent financial crises from occurring? While it is unrealistic to expect that regulators can prevent all problems from becoming crises, both history and current events suggest there are four key elements necessary for building and maintaining a strong financial system.

For the U.S., the Great Depression of the 1930s demonstrated the importance of having financial safety nets in place for the general public.

People should be able to put a limited amount of money in a bank without worrying about its safety. Ideally, the protection should be high enough to prevent bank runs, while still allowing for market discipline to be provided by the larger, more sophisticated market participants. A well-designed deposit insurance system can be a critical part of such a balanced financial safety net. Implementing that lesson is perhaps why the U.S. has not experienced another financial crisis as devastating to the economy as the Great Depression.

The downside of financial safety nets is that they can create incentives for excessive risk-taking. The U.S. learned this lesson during the savings and loan crisis of the 1980s and early 1990s. A strong regulatory, supervisory and enforcement framework must be in place to offset the potential for moral hazard. Risk-based capital standards and risk-based deposit insurance pricing can be important features of a strong regulatory framework. Regulatory safeguards that require a troubled bank to promptly take steps to

improve its financial condition or face resolution, instill public confidence and trust, particularly in times of stress.

The third lesson which we learned this year is that we need to ensure that financial activity that occurs outside the regulated banking environment is also subject to stringent standards and safeguards. The problems in subprime mortgage lending demonstrate how both consumer protections and underwriting standards can erode when non-banking entities replace regulated institutions in providing credit. Similarly, a lack of transparency and disclosure requirements created uncertainty about the risks of Structured Investment Vehicles that may not be fully captured through their funding and capitalization requirements, which are different than those imposed on banks that hold similar assets on their balance sheets. It is important to ensure that such opportunities for regulatory arbitrage are dealt with through consistent standards that ensure a level playing field for banks and non-banks alike.

The fourth and final point is that it is important to have a credible process in place for resolving insolvent banks. Sometimes financial safety nets for the general public, a strong financial regulatory framework and market discipline will not prevent banks from becoming insolvent. An explicit and operationally manageable framework for closing a failing bank, imposing losses on creditors and shareholders and providing safety net protections to depositors lessens the negative effects of a bank failure and helps maintain stability. Too little attention is paid to these issues. People are reluctant to talk about the operational issues associated with bank closings in part because they do not want to harm public confidence in banks. Yet the reverse should be true. If when all else fails, an insolvent bank can be resolved, the general public can be protected against catastrophic loss, and market discipline can be imposed in an orderly fashion, then financial stability can be better preserved over the long term. The public will gain confidence knowing that problem institutions will be subject to corrective actions that will restore them to a healthy condition or, if not, they will exit the system leaving behind a stronger and healthier banking system.

The best time to put these components in place is during periods of relative financial calm. Then, when the financial system faces stress, countries will have the mechanisms in place to minimize disruptions. Putting these components in place today helps to ensure a stronger, safer, and more secure financial system that can further promote economic growth and development throughout the world.

I would like to again thank the hosts of this conference for inviting me to be here today. I hope that my remarks about our experiences and the lessons we have learned are of some value to you as you move forward with the continued progression of your own financial system.

Thank you.

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