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I appreciate very much your kind invitation to speak with you today. It is always a pleasure to be in the Queen City of the Carolinas. It is a particular pleasure to be in this wonderful new place of learning and with such an accomplished group.

I have been told by one of your professors that a substantial number of you are seeking advanced degrees in finance, mathematical economics and accounting and that most of you, in one way or another, are concerned with the management of risk. These are important areas of study. In that regard, I would like to say a few words about the public policy debate regarding risk: what it has properly addressed and what it's missing.

As a backdrop, it is useful to remember what the financial services industry and our economy have been through since 2008: a major financial shock followed by a severe economic downturn. The financial crisis made it painfully apparent that the U.S. financial system was concentrated, highly levered and interconnected to an extent not fully understood by financial regulators. Risk management systems at major firms that were supposed to buttress the system did not function as advertised. The derivatives market, which was thought do be a source of stability through dispersion of risk, turned out to be both dangerously concentrated in firms that did not have the capacity to make good on their contractual obligations and insufficiently regulated. Regulatory arbitrage had left responsibility for some major firms a matter of mystery. For example, it took far too long to determine which agency had responsibility for AIG's financial products group – source of massive losses to shareholders and taxpayers. The answer, when finally discovered – the Office of Thrift Supervision – was not encouraging.

You are no doubt aware of the policy response to the crises: the Dodd-Frank Wall Street Reform and Consumer Protection Act. This is the law that the financial services industry loves to hate. While I won't attempt a blanket defense of Dodd-Frank, I would argue that it sets out a framework to regulate "too big to fail" firms that can work if stakeholders – industry, regulators, elected officials – make it work.

The Dodd-Frank Act created the Financial Stability Oversight Council (the "Council") to identify threats to financial stability, promote market discipline and respond to emerging threats to financial stability. To carry out its mandate, Dodd-Frank calls on the Council to, among other things, monitor the marketplace for threats to financial stability, identify gaps in regulation, and collect information from and facilitate information sharing among a variety of federal and state regulatory bodies.[1] The Council is chaired by the Secretary of the Treasury and includes the heads of the major federal financial regulatory agencies and an independent voting member with insurance experience. It also has five non-voting members, including state regulators and the Director of the Office of Financial Research ("OFR"), an independent body that advises the Council and has broad powers to collect market information in order to do so.

I believe it fair to say that the Council is the second most criticized agency established by Dodd-Frank, the Consumer Financial Protection Bureau being the first by a long distance. The major criticisms are that the Council does not directly address the problem of "too big to fail;" and that its operation requires the cooperation of a number of federal agencies and is, thus, cumbersome and presumptively ineffective. These policy criticisms are reinforced by the political fact that three members of the Council are acting heads of their agencies, and that a director of the OFR has not been nominated, much less confirmed.

While I acknowledge these criticisms, and agree with some of them, I submit that the Council deserves the support of all stakeholders in financial services. In the first place, I have it on good authority that the Council does work and is working. Highly competent senior staff from the federal agencies and leaders from the states are doing in-depth analysis of systemic issues on the basis of a growing body of commonly developed information. This is a huge improvement from past practice, in which turf issues between federal agencies and between the federal agencies and the states resulted in slow processes and suboptimal results. Rather than impeding progress, the Council's membership makes it likely that needed information and diverse points of view will be a part of policy formation. We saw this process working recently when, as reported in the press, the Council convened in the days after the S&P downgrade to discuss market movements. Operation of the Council over time should lead to better and more unified policy. If it does not, responsibility for failure will be clear.

In addition, under the Dodd-Frank regime and the most recent of the Basel Capital Accords ("Basel III"), it is more burdensome and expensive to be a systemically important institution. Dodd-Frank subjects a banking organization over $50 billion in assets or a non-banking firm, in either case designated by the Council as systemically important, to "heightened prudential standards" administered by the Federal Reserve and to an orderly liquidation scheme to be implemented by the FDIC. To that end, such firms are required to establish and maintain orderly liquidation plans and to file them with the Council. The intent of this provision is to insure that the risk of loss of a failure of such a firm is born by its owners and creditors. In addition, Basel III requires such firms to maintain Tier 1 capital equal to 9.5 % of total assets, which is substantially higher than the amount traditionally held by large firms. As my colleague Bill Haraf, California Commissioner of Financial Institutions and a non-voting member of the Council, has pointed out, this brings the big institutions all the way up to the level currently held by most community banks. That's progress.

[1] Dodd-Frank § 112(a)(2).

There are, of course, other approaches to "too big to fail." As a Jeffersonian / Jacksonian, I am partial to proposals to (i) limit the size of banking institutions to a fixed percentage of GDP[2] or (ii) break banks up into separate firms specializing in particular activities[3], building on the first step of the Volker Rule or (iii) both. Meritorious as these ideas may be, they were not selected by Congress, so they are just wish dreams. Further, as soul satisfying as "breaking up the big banks" may sound, it would be a hard lift practically, with a number of possible adverse consequences that may not be appreciated now. Let the record show that public intervention in the private economy has had mixed results. Finally, even in a downsized and Chinese walled world, regulators would still be confronted with issues of counterparty risk and loans to systemically significant firms (hedge funds come to mind). Whatever its defects, the Council is what we've got now to deal with systemic risk. We need to make it work.

Making systemic regulation work has as much to do with personal and collective will as with technical expertise. As the Council's Annual Report to Congress points out:

> Reducing threats to financial stability will require persistence, creativity, and a willingness to adapt more quickly to changes in markets. We must work to ensure that the regulatory framework keeps pace with the evolving global financial system. We cannot wait until we have passed the point of no return to strengthen safeguards against the type of race to the bottom in credit terms or underwriting standards that often characterizes periods of financial expansion. We need to be willing to act prudently and preemptively in the face of emerging vulnerabilities or imbalances.[4]

The "we" referred to in the passage I have just read is not just regulators. To be effective, it must also include the officers, directors and staffs of banking organizations and other systemically significant firms. "We" is you and I.

So much for what I think we have done right on systemic risk. What's missing? Adequate appreciation of the risk of failure by the financial services industry to perform its essential mission: meeting the needs of the American people. This is the most significant risk of all because it affects the public view of the integrity of our financial and regulatory systems.

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[2] Simon Johnson and James Kwak, <u>Thirteen Bankers: The Wall Street Takeover and the Next Financial Meltdown</u> (New York Pantheon Books) (2010).

[3] Herbert M. Allison, Jr., <u>The Megabanks Mess</u> (Kindle Single available at http://amzn.com/B005IGQXII) or Twitter: @bankmess.

[4] FSOC 2011 Annual Report, ii.

This is not an idle thought of mine, or at least of mine alone. It is also on the mind of Herbert M. Allison, Jr., former President of Merrill Lynch and former Chairman and CEO of TIAA-CREF, two institutions of which I suspect you are aware. In his recent book, The Megabanks Mess, Allison gives his view of our mission as follows:

> America needs a financial industry that is committed to meeting individuals' need for building financial security over their working lives, shareholders' need for adequate return over time, and the public's need for protection against periodic financial meltdowns that destroy jobs and savings.[5]

This mission statement follows a detailed and critical assessment of the performance of the banking organizations that dominate the financial landscape today. Allison finds that these firms failed to achieve any of the foregoing goals – including returns to shareholders - by emphasizing profit to the exclusion of all else. He goes on to propose the breaking up of what he calls the "megabanks" into focused organizations that perform one of the major functions required of the financial services industry – retail advisory, capital markets or wholesale, investment companies – without the inherent conflicts of interest that the current universal bank model entails. Such enterprises would, in this construct, be client focused first, with accrual of shareholder value the result rather than the goal. He is also critical of the past and current regulatory structure – including the Council and CFPB. All of us are part of the problem.

Is Allison right? Do financial services firms and their regulators lack what he calls "client focus?" A crucial question in this regard is whether we view customers (clients, if you prefer) as the *subjects* or the *objects* of our work. That is to say, is a client someone you work *for* or someone you work *on* as part of working for yourself? This isn't just sophistry. I would argue that the negative and visceral response by a large number of our fellow citizens to TARP, the travails of Fannie Mae and Freddie Mac, and proposals to aid distressed mortgage borrowers come from the belief that we – you and I – don't work for them. Former Fed Chairman Paul Volker has said that the major benefit from deregulation and the innovation it is said to have fostered is the ATM. I would suggest that average citizens share this view. Even a cursory review of their balance sheets does not show a material increase in wellbeing from all that we have done. It does show a lot of leverage, pitiful savings, and depressed or non-existent investments.

Are we responsible for the plight of our fellow citizens? No, but that doesn't mean we get a free pass. The conduct of financial services companies in the subprime market aided and abetted foolish decisions by borrowers that have resulted in damage to them, to lenders, to capital markets and to innocent taxpayers. The ethics behind the conduct of a number of major derivatives market makers – aiding and abetting the creation of securities that were virtually certain to fail and then shorting them – escapes those of us who lack their sophistication and technical prowess. So does the treatment of distressed borrowers by credit card issuers and mortgage servicers. In each of these

[5] Allison, *op cit,* note 2.

cases, relatively powerless or unsophisticated customers have been treated as *objects*, not *subjects*. This perception of the relationship between financial services providers and those they purport to serve is damaging to public trust and confidence in them and in our financial system as a whole.

Whatever one thinks of Herb Allison's analysis and proposals for reform, what are the public needs that the financial services industry should address? This is a serious question that involves serious strategic risks for all banks. What is the business model for the future? Where are banks' earning assets going to come from? Given our current economic circumstances, the list of needs is a long one. Let me mention a few areas that need attention:

- Real estate finance, both commercial and residential. While real estate is blamed for a significant portion of the industry's ills, restructuring and refinancing existing facilities is crucial to economic recovery.
- Housing. As it appears likely that federal support for both home ownership and rental housing is likely to decline, private market approaches to the housing needs of our country are critical.
- Retirement savings. The studies of this topic that I have seen are worrying to say the least. We are not, on the whole, saving enough to meet our foreseeable needs in old age. The current migration from defined benefit to defined contribution plans makes individuals responsible for disciplined saving and asset allocation of investments. There is little or no evidence that most people are up to these tasks. Addressing this need will have a direct impact on the wellbeing of senior citizens and our economy generally in the not too distant future.
- Small business lending. This is a critical need going forward as it is generally agreed that most job growth in our economy will come from small firms.
- Banking low and moderate-income individuals. This is the unsung corollary to small business lending. Most employees of small business work for low wages. They are often uncomfortable with mainstream banking and vice versa – banks are not always familiar and comfortable with them. Yet they are the people most in need of help in managing their limited finances. Failure to meet their needs can lead to reduced productivity, low job satisfaction and turnover. If we are serious about helping small business, we should bank their employees.

Meeting each of these needs brings with it daunting challenges, including regulatory challenges. That said, addressing them can do much to restore the financial services industry and our economy to health. It can also buttress trust in our financial system and government.

Am I suggesting that you quit your day jobs and go to work for government or a non-profit? Not at all. As the great legal scholar Karl Llewellyn once wrote, "technique without ideals may be a menace, but ideals without technique are a mess."[6] Addressing

[6] Quoted in Smith, "Home Mortgage Lending: Past Present and Future," 15 N.C. Banking Institute 1 (2011) at note 1.

public needs requires a careful balancing of the needs, possibilities, risks and costs, so that they can be met in a sustainable way over time. Your use of your quantitative and analytical skills to achieve this balance is a public service, no matter who signs your paycheck. That said, it would be great if some of you applied your skills to regulatory work. We need you.

To conclude, the financial crisis and its aftermath have led to some changes in policy that can and should reduce risk to our financial system and lay the groundwork for recovery and greater stability. Policy changes alone, however, are not enough. As the first annual report of the Financial Stability Oversight Council points out:

> A stable financial system cannot be maintained by regulation and oversight alone. Those in positions of leadership in the financial sector will need to establish and maintain much higher standards for integrity and a more sophisticated understanding of the risk inherent in the business of finance than prevailed before and during this crisis.[7]

All stakeholders need to work together to effectively implement both policies and industry practices that produce stability, sustainable growth and public confidence. I wish you the best of luck in your future endeavors – academic and in practice – and look forward to working with you toward those important goals.

Thank you.

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[7] *Ibid,* iv.