

Bob Herz
FASB
December 8, 2008

**Lessons Learned, *Relearned*, and *Relearned Again* from the
Global Financial Crisis—
Accounting and Beyond**

Over the past twenty years, we've experienced several major financial and economic crises, including the S&L crisis, the reporting scandals and dot.com bubble in 2001-2002, and now, over the past 18 months, the ongoing crisis in the credit and financial markets which many have characterized as potentially the most severe economic crisis since the Great Depression.

Each time there are a number of lessons to be learned from these events. But, unfortunately, some of the lessons seem to be forgotten and have to be "re-learned" again and again multiple times.

And, each time, in addition to the "blame game", people look back and try to understand where things went wrong and to assess what can be learned from the experience. That's appropriate and healthy. I think one of the strengths of our country is our willingness and ability to acknowledge problems and to try to address them in a timely fashion. Indeed, we have witnessed swift and strong actions by the Treasury, the Fed, the FDIC, and by Congress to keep our financial system and our economy together. And, of course, this time the crisis has been a global one, starting with the collapse of the U.S. housing market, leading to a credit crisis here and abroad, then to a full fledged crisis in the global financial markets, and now to a global recession. And so governments, monetary authorities, and regulators

across the world have taken a variety of unprecedented measures both in their individual jurisdictions and, in some cases, on a coordinated international basis, to try to stem the crisis.

So, from my particular perch in the capital markets, let me give some of my own views on the crisis and some lessons to be learned and perhaps re-learned coming out of it.

Let's look at what happened so far and why. These are my own views and I am sure many will not agree with some or all of these views. Also, I hope I don't offend any one with my frank assessments. That's not my intent. Rather, I offer my perspectives as part of the ongoing dialogue and analysis of recent and ongoing events and in the spirit of continuing and hopefully durable improvement in areas critical to our capital markets and our economic welfare.

Just as was the case in the S&L crisis and with the reporting scandals and dot.com bubble, there seems to have been a number of systemic issues behind the current crisis. While some of these issues are new, some of them are not so new. Government policies in the post 9/11 era promoted excessive liquidity in the capital markets and rapid expansion of home ownership. At the core of the credit crisis was the explosion of so-called "non-traditional" loans, including sub-prime mortgages, with all sorts of novel payment (or perhaps I should say non-payment) terms that enabled millions of new people to achieve, if only temporarily, the dream of home ownership, many others to refinance their existing mortgages, and speculators to purchase second, third and fourth homes, condos, and apartments as if they were trading commodities. These loans were then passed on by the mortgage brokers, many of whom were not regulated, to the

major Wall Street firms who packaged them into an ever increasingly complex array of structured securities, wrote a mountain of credit default swaps and other derivatives related to these securities, and sold these to other financial institutions, hedge funds, and investors hungry for enhanced yields in an era of historically low interest rates and even inverted yield curves.

These institutions and investors, comforted in the belief that the rating agencies had carefully examined and modeled the risks in arriving at their rating of these securities, apparently saw little need to conduct their own due diligence, risk management, modeling and valuation processes. Now, as in 2001 and 2002, we find out that there may have been process and other problems at the rating agencies, once again leading some to question the validity and value of ratings.

And as the music grew ever louder, the dance, premised on an apparent belief that U.S. home prices would continue to rise or at least not decline, became ever more frenzied, with the leaders of some institutions seemingly willing to bet the ranch on the dance continuing, apparently unchecked by either boards of directors or by regulators, until once again, just as with the prior bubbles, the music stopped, the bubble burst, and things started unraveling and the credit markets seized up. Major financial institutions faltered, failed, and had to be rescued, economic activity slowed and recession set in.

Perhaps a bit of an exaggeration and oversimplification of what we have witnessed, but not far from the truth if you read the many very good studies on the credit crisis that have been issued by

groups such as the President's Working Group on Financial Markets, the Financial Stability Forum and the G20, and the reports of the Institute for International Finance and The Counter Party Risk Management Policy Group and as we contemplate the historic events of the past few months that are reshaping our financial services markets and the level of direct government involvement in them.

As I said, at the heart of this chain of events was the explosion of novel mortgages and other loans. While lax and fraudulent lending practices were seemingly the prime culprit, there are two sides in a lending transaction and many consumers eagerly snatched-up "too good to be true" loans, without understanding the consequences. At its height, the frenzy was reminiscent of the investment craze in dot.com stocks. In both cases, misplaced investor enthusiasm was, in my view, due at least in part to widespread financial illiteracy in our country, along with a belief that somehow this time the situation was different and prices would rise forever.

If you think about it, beyond the very significant challenges posed by the current crisis, one of the biggest longer term problems in our country is retirement security. Social Security and Medicare are overextended and in danger of becoming insolvent over the next 25-40 years. And, in the private sector, employers, who for many decades provided workers with retirement plans and medical coverage, have been increasingly shifting the responsibility for these matters to employees.

So people are understandably looking for promising investment opportunities to grow the largest nest egg possible to provide for their retirement security, to meet the rising costs of healthcare and college

tuition and to create personal wealth. But for this approach to succeed, our population must be more financially literate. And this strategy can't work if every six or seven years the nest egg gets broken and scrambled.

Today, our financial markets are more complicated, more global, and more interconnected than ever. Securitization and structured finance created a vast array of complex securities that were spread around the world. What had once been relatively straightforward securitization transactions evolved into more complicated structures such as collateralized debt obligations, or CDOs. But it didn't stop there as those instruments morphed into CDOs *squared* and mountains of derivatives like credit default swaps written on these complex securities. And making it all possible were supposedly sophisticated investors--including major financial institutions—some of whom as I said seemed willing to bet the ranch on this strategy.

And, once again, we have witnessed apparent lapses in corporate governance at major companies. For despite the recent emphasis on increased corporate governance and internal controls in the post Sarbanes-Oxley era, the risk management and due diligence processes at a number of major financial institutions didn't seem to be particularly apparent or effective. Positions were leveraged and leveraged again and again. Once again, investors found themselves asking, "Where was the oversight from the companies' boards: why weren't the directors reining in these activities or at least asking tough questions?"

And it is also now clear that in a relatively short period of time, there was a rapid and explosive growth of unregulated, opaque markets that lacked a proper infrastructure, such as the transparent pricing and clearing mechanisms.

To some observers, it was a “Wild West” version of financial markets in which the unchecked growth of products such as credit default swaps could suddenly swell to over \$60 trillion in notional value, prompting the question: “Where were the regulators?” Unfortunately, balkanized regulatory systems, both in the US and across international financial markets, coupled with a deregulatory philosophy by some key folks in Washington, D.C, may have made it difficult, if not impossible, to rein in the exuberance driving the markets. And just as in the S&L crisis, regulators apparently failed to fully understand the risks their regulatees were taking on and apparently thus saw little reason to try to curb what turned out to be mounting problems.

The crisis also revealed several accounting and reporting issues, such as those resulting from an apparent continued addiction by some in corporate America to “off-balance” sheet treatments, and an aversion to providing full and forthright disclosures on the risks facing their institutions. The concept of Fair Value, which was intended to help bring transparency, was scorned by some as a villain, exacerbating the turmoil, and heralded by others as a savior in revealing the problems on a timely basis.

So what lessons should we learn from all of this? While the unfolding events seem to provide new twists and turns almost every

day and while there are certainly some new lessons to be learned, at the same time others seem hauntingly familiar as factors in past crises. And I think there are lessons for just about all of us in the capital markets, including my organization as a standard setter. So, here's my list of some of the key lessons to be learned and, in some cases relearned, as well as some important questions that I feel need to be asked:

- Remember the risks.
- Liquidity matters.
- The double edged sword of leverage
- “Out of sight, out of mind”
- “Buyer beware.”
- Accounting has consequences—but, can we handle the truth?
- Mind the exceptions.
- Good reporting requires both sound standards and faithful application of those standards.
- Fair value— villain or savior?
- Sound markets require a proper infrastructure.
- Self-regulation may be no regulation
- Fundamental changes are needed in our capital markets and financial services industry.
- Global problems demand global solutions.
- Perverse incentives lead to perverse outcomes.
- Each crisis brings many challenges, but also many opportunities for change and improvement.

Let's take a closer look at each of these:

First, remember the risks and don't ignore or underestimate the tail risks or the "Black Swan" effect, for once again we have heard the Wall Street rocket scientists musing "who would have ever expected the 'ten standard deviation' event to happen **AGAIN?**"

To me, the simple truth seems to be that the models work until they don't work. In a changing world, the past is not necessarily a reliable guide to the future, especially when the basics change, like the nature and volume of mortgages with novel terms that significantly elevated the cash flow risks.

And liquidity matters. Once again we learned that without liquidity, markets for even the most highly-rated investments evaporate, causing seemingly well capitalized institutions to falter and even fail. And it certainly mattered when it came to the functioning of conduits and SIVs and to auction rate securities. By the way, the basic problem that brought down some of the SIVs and conduits was one of duration mismatch, i.e. borrowing short term to fund long term assets, which was also one of the problems behind the S&L mess 20 years ago. Eventually the whole system becomes frozen, requiring government intervention.

And we have again witnessed the double-edged sword of leverage in terms of fueling a bubble and quickly leading to a bust when the bubble bursts and the deleveraging process begins.

As a consequence, no matter how promising the markets may currently seem, even the most sophisticated investor needs to consider all opportunities from a perspective of "caveat emptor" or "buyer beware."

Next, let's talk about the "out of sight, out of mind" approach to investing, risk management and reporting. Moving from a model of "originate and hold" to "originate to distribute" may have momentarily satisfied the urge to get items off the balance sheet, but are the risks and obligations really still there? How much of this was driven by financial reporting objectives vs. by regulatory capital treatments? And would the underlying problems have surfaced and been addressed earlier had these items been on balance sheet?

Also, ignore current market/fair value at your peril for it may provide a critical signal of underlying problems and truths. And accounting has consequences, it's meant to, otherwise, why do it? In other words, "can we handle the truth?" External financial reporting is not merely a compliance exercise, nor is it an opportunity for spin. Nor is it focused on regulatory capital requirements or the "safety and soundness" of particular institutions. That's the job of the financial institutions' regulators. Rather the primary intent of external financial reporting is to provide transparency, to inform investors and the capital markets. What you measure matters! And, transparency and accountability require honest accounting and informative disclosure, even when the news is bad.

Unfortunately, as we have seen in the past, some corporate executives try to manage the story through accounting, particularly when there is bad news or to try to cloak the effect of their bad decisions. And when complying with a particular standard would present a less flattering picture than desired, some folks may employ a "shoot the messenger" tactic of blaming the accounting

requirements or the auditors rather than owning up to their prior poor business decisions and faltering financial condition.

So can we handle the truth? Side stepping the truth by blaming the accounting as misportraying reality and causing “procyclical” effects is tantamount to trying to “shoot the messenger.”

But that’s not to say that the standards are perfect, both in terms of their requirements and in terms of their application in practice. Good reporting requires both sound standards and faithful application of those standards

In that regard, neither FAS 140 on transfers of financial assets nor FIN 46(R) on variable interest entities are God’s gift to accounting. While the basic concepts underlying these pronouncements are relatively simple, their implementation can often be challenging. But let’s also try to understand, with the benefit of hindsight, what seems to have occurred in recent years.

Let’s start with FAS 140 and the concept of QSPE’s or as people refer to them, “Q’s.” Q’s were meant to be passive pass-through type entities—essentially a lock-box: the money from the collateral comes in, gets collected and distributed to the security holders. This notion of passivity and of the cash flow belonging to the security holders was important in affording Q’s off balance sheet treatment.

Indeed, the concept of passivity was reinforced by specific requirements for Q status under FAS 140 that the activities of the SPE be significantly limited and entirely specified up front.

But the concept was stretched and stretched and stretched to the point where sub-prime loans were put into vehicles with layers of

complex securities issued, backed by what turned out to be highly problematic collateral that would require active management and large scale restructuring of the loans.

We now know with hindsight that some of these entities, treated as Q's for accounting purposes, were effectively ticking time bombs. As the loans contained in them increasingly went bad or became in danger of going bad, all sorts of actions and active management were needed that went well beyond those contemplated by FAS 140.

I had said publicly in a FASB Board meeting a while back that my worst nightmare is that I'm walking down Wall Street and I look up at a 70-story building... and at the top a sign reads "XYZ Corporation —a QSPE." ...And inside that building there are 10,000 people managing a supposedly passive entity.

As I noted, QSPEs were originally intended as passive entities but morphed into something different. Unfortunately, it seems that some folks used Q's like a punch bowl to get off-balance sheet treatment while spiking the punch. That has led us to conclude that now it's time to take away the punch bowl. And so we have proposed eliminating the concept of a QSPE from the U.S. accounting literature.

By the way, I think there is another important recurring lesson here for us as standard setters – mind the exceptions, particularly those that confer a highly desirable accounting result. In addition to adding complexity for preparers, auditors, and also for investors, over time they can lead to trouble. For no matter how carefully you believe they may have been crafted, companies desirous of getting that favorable accounting will try through a variety of means to avail

themselves of it, inevitably causing the exception to get stretched, abused, and violated, resulting in new rules to try to curb the perceived abuses and ultimately in the exception being eliminated. I think that's what happened with poolings of interest, with fixed price employee stock options, and now with QSPEs.

Let's now talk about FIN 46(R). We issued that standard in the wake of the abuses with off balance sheet entities by Enron and others under the so-called "3% rule." The basic concept in FIN 46 (R) is simple - for thinly capitalized entities that do not meet the Q requirements, the party that holds the majority of the risk and/or reward of the entity is deemed to be the "primary beneficiary" and should consolidate the entity. That determination is based on a calculation of what are called "expected losses."

However, what we have found out in hindsight is that those calculations didn't always include all the relevant risks, perhaps reflecting the general irrational exuberance of the times. Clearly, as events have shown, a key risk that was not properly factored into these calculations was liquidity risk.

Some institutions also sought to structure around FIN 46(R) by creating and selling so-called "expected loss notes" that were designed to transfer the majority of the expected losses to a third party buyer. But did they actually transfer the majority of the real risks? If not, was this just poor estimation or was that by design, for example, through reverse engineering of the terms of these securities to be able to claim they transferred over 50% of the expected losses? We do not have regulatory review or enforcement powers, but I

wonder. In any event, it's also time to revise FIN 46(R), and so we are also proposing significant changes to that standard.

Investors have also, with justification, complained that they were blindsided and that these risks should have been disclosed. In fact, there are many existing disclosure requirements in this area; ones in FAS 140 related to retained interests, ones in FIN 46(R) around the purpose of a VIE and the nature of an enterprise's involvement with each VIE and a requirement to disclose the maximum loss that could be suffered by the reporting enterprise due to its involvements with non-consolidated VIEs. Moreover, there are all the disclosure requirements enumerated in an FSP on "non-traditional loans," that we issued in December 2005 to try to alert people to the fact that holding such loans or investments based on them or servicing them could create unusual types of risks that may need to be disclosed under the existing requirements. Interestingly, part of what triggered our putting out that FSP was that many of us at the time were getting scores of daily junk e-mails on being pre-approved for all sorts of no doc, no income verification, teaser rate and negative amortization mortgages. So we inquired of our banking regulator colleagues about the extent to which such loans were actually being written. On discovering that lots and lots of them were being written, we decided to issue the FSP.

Unfortunately, again perhaps reflecting the overall optimism of the times, all of these requirements did not always elicit the types of clear and forthright disclosures investors were looking for. Apparently, the attendant risks were viewed as either immaterial or

remote or both. The Black Swan was out there, but was either not recognized or ignored.

And so we are significantly expanding the required disclosures, making them tighter and more specific so that hopefully even when the music is playing, the potential risks get disclosed. And as I noted we are proposing significant revisions to both FAS 140 and FIN 46 (R) that we believe will result in many, if not most, securitizations and VIEs being on balance sheet. These changes are needed in the short run in response to reporting issues that have arisen in our country. Ultimately, however, we believe that there needs to be solid international standards in this area and so we are also working with the IASB on developing more comprehensive standards on consolidation and derecognition.

Let's now talk about fair value? There are clearly issues with fair value, particularly in illiquid markets, and for the highly complex securities and derivatives that were created in recent years, but that doesn't mean it shouldn't be reported, supplemented by useful disclosures. So, let's understand some basic facts about fair value because unfortunately, there has been a lot of incorrect information circulating in the media and elsewhere about it. A couple of basic points:

1. The use of fair value in financial reporting is hardly new. FAS 157 did not, as some have asserted, require any new fair value measurements. Rather, fair value has been used for reporting of securities, derivatives, and many other financial assets for many years. In some cases, for example, for broker-dealers and trading

accounts, mark-to-market and fair value accounting have been required for decades. In other cases, such as with held-to-maturity and available-for-sale securities, it is used to recognize impairments. And many of the financial assets, probably most for many banks, including loans, are not on a fair value basis.

2. Equally important, the idea that in down markets assets should be written down to lower of cost or market or lower of cost or net realizable value, has been a fundamental concept in accounting for a century or more. So even if you do not agree with so-called full fair value accounting, that is, marking assets to market both in up markets and down markets and reflecting the changes in value in net income, the requirement to write down the value of assets in bad markets is hardly a new one.

So, what is new? First, of course, and perhaps of most relevance, is the fact that over the past year, as the extent of problems in the U.S. housing market become more evident and the credit crisis deepened and widened, more and more financial assets, particularly those backed by or tied to mortgages, for which there may have previously been active markets, have by any measure suffered losses in value and have become increasingly illiquid. Under such circumstances, deriving fair value estimates often has had to rely on unobservable inputs (what FAS 157 terms Level 3 estimates). Like many other estimates used in financial reporting (some of which also require complex calculations), developing Level 3 estimates can be difficult and require significant analysis and the use of significant

judgment. However, many investors clearly have indicated that such estimates provide more relevant and useful information than alternatives that ignore current economic conditions, including lack of liquidity, and that can introduce management bias into the estimation process (for example, alternatives that involve “smoothing” techniques and predicting recoveries in value). In fact, in a survey earlier this year of over 2000 investors conducted by the CFA Institute, an overwhelming majority of respondents (79%) said that for financial institutions, fair value accounting improves transparency and contributes to investor understanding about risk.

What is also new are the expanded disclosures under FAS 157 that focus on the methods used by a company to report fair values and their impact on reported results and financial condition with particular emphasis on the Level 3 fair values.

The SEC staff have also issued two letters encouraging public companies to provide additional useful disclosures in MD&A about their use of fair value and its impact on the financial statements.

Nevertheless, some have periodically complained that its use understates the “true value” of securities in illiquid markets, thereby overstating the extent of the “true” losses. For example, last October they argued that a security with a fair value of say \$80 was really worth \$95, and in December when the fair value of that security had fallen to \$60 they argued it was really worth \$70, in March that the fair value of \$40 should really be \$55, and so on all the way down until, for example, the security was sold for say \$25 in July. And if anything, the values of such securities have continued to fall, with few buyers

seemingly interested in acquiring them even at severely depressed prices.

Unfortunately, so far these assertions have proven Pollyannaish as the extent of toxicity of and underlying cash flow problems with these securities became more and more evident resulting in continuing declines in the values of the securities over the course of the last 18 months and with some of the institutions making these assertions amongst those that have failed and/or had to be rescued by the Treasury and the Fed.

To be sure, there is no question that implementing fair value in illiquid markets can be challenging and difficult and there are important questions to be asked. Does it lead, reflect, or lag reality? Are there genuine concerns over procyclicality? These are important questions and issues; but I would ask, what are the alternatives? To use original cost or some other smoothed value that ignores current market conditions, or to rely solely on management estimates of the value that may ignore current market conditions and that thus far have often proven highly overoptimistic? Yet, in some cases, that is what some people have asked us to do—suspend or sugar coat the bad news for a while...until things get better. That is what happened in the S&L crisis under bank regulatory reporting and is also what Japan tried to do rather unsuccessfully for over a decade.

Those demanding a suspension or modification of fair value requirements claim that its use has contributed to an unnecessary downward spiral in the financial condition of financial institutions and the stability of financial markets. While these concerns and assertions may be understandable from a financial stability

perspective, they seem to miss the basic point that accounting and financial reporting are meant to inform investors and the capital markets and that straying from that objective or subordinating that objective to any other corporate, industry, social or economic objective other than sound and transparent reporting, can also cause financial instability due to loss of investor confidence in the reporting by companies.

So to what extent has the use of fair value contributed to the financial crisis? Well, that is one of the questions that Congress has asked the SEC to study. Without in any way attempting to pre-judge the results of that important study, let me give you a few more facts:

- For the 17 banks closed by the FDIC between January and October 2008, net assets carried at fair value represent just 10% of total assets on average (range 0% - 37%). Indeed, once you get past the handful of the largest banks that have significant trading and available-for-sale portfolios, fair value accounting applies to a relatively small proportion of the assets of most banks, with the bulk of their financial assets represented by loans carried on a historical cost basis subject to loan loss allowances that are not on a fair value basis.
- But, investors' pricing of banks suggests that they view bank net assets as overstated, not understated. Based on November 3, 2008 stock prices, 59% of all US-listed banks (427 banks) were trading at less than book value; 291 of those banks were trading at less than 80% of book value and many at less than tangible book value.

So it is not surprising that when we talk with professional investors and financial analysts, their view seems to be that the problem is not too much use of fair value by banks, but too little.

Indeed, some commentators on the current financial crisis point to investor and counterparty suspicions over the quality of valuations and disclosures relating to exposures to troubled financial assets made by certain financial institutions as factors contributing to the financial collapse of these enterprises and as one of the reasons for the apparent continued reluctance of banks to lend to each other. Also, if financial institution regulators do not like the consequences of fair valuing financial assets on the regulatory capital of covered institutions, they have some flexibility to adjust their rules to provide forbearance.

Most investors have been clear; they want to see the current fair values of a company's financial assets. They believe it is the appropriate method of accounting for such items and preferable to the current complex mixed attribute accounting for financial assets, and they generally applaud the added transparency provided by the new disclosures under FAS 157 (and indeed would like some additional disclosures like ranges and sensitivities).

Why is this so? Well, think about your own finances. If you were looking to get a loan, what values would a responsible lender put on your assets, such as your house or your investments? Would

it be cost? Would it be some smoothed value that was higher than their current value in a sale? Would it be the value you are hopeful of getting in a better economy in the future? I doubt it. And when you get your monthly brokerage statement in these down markets, does it substitute some smoothed values or some “fundamental” values or some potential future values for the current market values? And when you suffer a decline in your net worth, even on an unrealized basis, you might be prompted to take some “procyclical” actions like spending less, or even selling some assets to raise cash. But, in tough times, surely we don’t want people spending less and selling investments, that will only help deepen the recession. What we need is people spending more and buying assets. So why don’t we just pass a law requiring broker-dealers to send out monthly statements to their retail customers that show nicely rising values, thereby engendering consumer and investor confidence, spurring more spending and helping us climb out of a recession. But, of course, people could still go to newspapers, the internet, Bloomberg, or CNBC to find out the current values of their investments. So maybe we should also muzzle or alter these sources of information in bad times. Sound like I am exaggerating and even getting ridiculous?

Perhaps. But how far is that from some of the arguments made by certain leaders of the business community and politicians over the past year?

The harsh reality is that we can't just willy nilly suspend or modify the financial reporting when there is bad news. Changing the accounting does not make the underlying problems go away. That's not so say that we shouldn't be considering additional guidance or that fair value is perfect or is the universal panacea. Markets are not perfect valuation mechanisms. There are difficult issues, particularly in illiquid and inactive markets. And, therefore, both we and the SEC staff recently issued additional guidance specifically dealing with valuing financial assets in inactive markets and we have been holding global roundtables with the IASB to get broad input on what else we might do to expeditiously improve reporting in these very challenging times.

Which brings me to my next point: Mark to market works best in sound, transparent, active, liquid markets. Therefore, while it is in our collective interest to try to keep improving disclosures and techniques around valuing items in illiquid markets, it might be even at least as

worthwhile to try to take the steps necessary to create sound markets.

For I believe that another key lesson learned and relearned is that sound markets require a proper infrastructure to facilitate the flow of information, ascertain price discovery, support the necessary clearing mechanisms, and allow for informed and knowledgeable market participants. Effective oversight and regulation are also key ingredients of sound markets, as are the exercise of appropriate due diligence by investors and proper risk management processes by financial institutions. And I think we should be asking ourselves whether the world can get by without all the complex financial instruments that were conjured up in recent years. In that regard, I applaud the SEC and IOSCO for recently forming global task forces to look at the issues of unregulated markets and products and unregulated entities.

So while the \$700 billion emergency economic stabilization program enacted by Congress will hopefully help reliquify the credit markets, more lasting changes and improvements in our financial markets structures and mechanisms will be necessary.

I think all of this points to the fact that our regulatory architecture needs to be rethought. Over many decades we have built a highly fragmented, balkanized regulatory structure over our financial services and capital markets. In some cases, self-regulation appears to have been tantamount to no regulation. Moreover, there are black holes of little or no regulation. There are five different federal banking regulators and each state has a banking regulator. Yet with all of this supposed regulation of lending institutions, many of the problem loans were made out of non-regulated entities. And what about insurance? Each state has a regulator, but there is no national one. And there were issues relating to the regulation and oversight of the commercial banks vs. the investment banks, of the jurisdiction of the SEC vs. the CFTC, and of the extent to which other key players like hedge funds should be regulated. And to what extent are there contradictory objectives, for example, between safety and soundness vs. investor protection built into our current regulatory architecture.

In that regard, in a recent editorial in the Wall Street Journal, former SEC Chairman Arthur Levitt noted that “banking regulators have one concern, but it is not investor protection.” I believe that it is imperative that this point be borne in mind in any redesign of our

regulatory system so that the interests of investors and consumers don't get shoved aside in favor of other public policy goals. In that regard, it is critical that accounting standard setting remains independent and oriented toward establishing standards that promote useful and transparent financial information for investors and other users and not be geared to fulfilling other objectives, as some have suggested.

Not surprisingly then, even before the onset of the current crisis, there had been calls to rethink the current US regulatory system. Some point to systems, such as the UK, where there is a single financial capital markets regulator. That's one model. There are regulators like that in other countries, but they have also experienced some problems in the current crisis in detecting and addressing problems in their jurisdictions.

And also before the onset of the current crisis, Treasury Secretary Hank Paulson released a blueprint for regulatory reform of the markets. I'm not going to comment on the particular solutions proposed in that report other than to say that I think it highlights a very real issue. Our financial system architecture has been built-up

on a patch-work basis and there now seems to be a growing consensus that it is time to rethink it.

That's in the US. However, increasingly global and interconnected markets demand global solutions. While the credit crisis may have originated in the US, the shock waves have reverberated around and engulfed the rest of the world. So it's not surprising that while some may accuse China of exporting toxic toys—we are being accused by some of our foreign partners of exporting toxic securities. Unfortunately, there is some truth to this accusation and now after having seen both the dot.com bubble and the unfolding crisis in our financial markets and financial services industry, some of our foreign colleagues are understandably questioning our ability to run sound capital markets. We need to take this seriously. Our capital markets have been one of our crown jewels. We can't risk a sustained loss of confidence in them.

The good news is that as I said earlier, as a country we are generally quick to recognize and address these types of problems. We have certainly witnessed that in recent months first in terms of strong actions by the Treasury, the Fed and the FDIC as specific major financial institutions faced imminent failure and now in terms of

more systemic actions by the Administration and Congress under the Emergency Economic Stabilization Act of 2008. It is also good that there is increasing international cooperation on these issues, whether it be through market-led efforts such as those by the Institute for International Finance or the Counter Party Risk Management Policy Group, or through increasing collaboration and coordinated efforts by regulators, central bankers and governments through the Financial Stability Forum, the Basel Committee and the G7 and the G20, or through the many joint efforts in accounting standard setting between us and the IASB. This is all well and good, but it is also possible that more formal global structures may be needed to deal with what are increasingly global capital markets and the interrelated issues and challenges across those markets and to prevent undesirable regulatory arbitrage across markets.

Finally, as seems to be the case in other past crises, I believe that the problems that have emanated from the current crisis again demonstrate that perverse incentives often lead to perverse outcomes. History is replete with examples. In this case, we had this “originate to distribute” model where the first party says, “Lend it, get

a fee, and then get it off my books.” The next person says, “I can package and securitize it, get it off my books.”

Everyone was moving the puck around. As the puck moved, the prior possessors of the puck seem to have felt that they had passed on the risks, not worrying much about the original loans and the introduction of potential systemic risks created by passing the puck around and adding leverage and complicated bells and whistles. And, once again, we had major corporations, or at least the leaders of those companies, willing to take huge risks looking for a huge corporate, and perhaps personal, payday.

From my perspective, I think few object to Bill Gates or Warren Buffet being worth billions, because they think they are unique people who have added tremendous value to their shareholders and employees and to our society. But I think it really rubs many people the wrong way when the CEO of a large company gets paid \$150 million during the three or four years he was in charge and, then, after he’s run the place into the ground— is given another \$50 million to leave— I think that angers a lot of people. In the past, when I voiced this point of view, some called me crazy and an anti-capitalist. To the

contrary, my concern has been that these practices were eating away at the fabric of our capitalist society.

I'm heartened that there now seems to be more widespread recognition of this problem and the prospect of dealing with it in a meaningful way and that the leaders of some major financial institutions have voluntarily agreed to forgo bonuses this year.

And, as in previous crises, there seem to have been all sorts of conflicts of interest, by the ratings agencies, the mortgage brokers, companies, compensation committees, and in terms of self-regulatory schemes.

Do some of these sound familiar?

Now, the BIG question is: This time are we going to truly learn our lesson from these experiences?

Once the financial markets have been stabilized, it will be the job of governments, legislators, regulators and standard setters to carefully understand what has occurred and develop the necessary strategies to try to set our financial system and our economy on a path to renewed health, to sustained growth and to being able to avoid repeating the mistakes of the past. At the same time, we must make sure that our cures don't kill the patient.

But in the final analysis, increased government involvement in the financial services industry, better regulation, sounder standards, and more effective enforcement can only go so far. Market-led reforms and solutions are also critical to ensuring the sound and effective functioning of our financial and capital markets and to help avoid a repeat of recurring problems.

But just don't look for others to fix problems that may be under your control. Keep the Golden Rule of 'doing unto others as they would do to you' in mind. If you are a lender, don't make loans that people may not be able to pay off just because you can sell or securitize them. And if you are in corporate reporting, don't succumb to the temptation to try to structure around the standards or fail to properly communicate risks to your investors and the markets, just because there is no specific FASB or SEC requirement. For transparency is critical in both good and bad times.

And, very importantly, as I have tried to stress in my comments today, I feel that all of us in the capital markets must devote ourselves to understanding the underlying causes of these problems, to learning the lessons they afford, and to taking the actions necessary to avoid repeating them in the future. Maybe then we can begin to

break the cycle of boom/bust/bailout and propel the economy, our nation, and the global markets to new levels of economic growth and prosperity. While we have some very rough times ahead, I am optimistic in our collective ability to learn from these experiences and to take the right steps toward renewed growth and prosperity, particularly in light of what for many of us may be some indelible memories emanating from the current crisis. But, if not, I may be back to give this speech in another six or seven years.