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History Doesn’t Repeat Itself, People Repeat History—
Front-Line Thoughts and Observations on Creating a Sounder Financial System

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The views expressed in this presentation are my own and do not necessarily represent official positions of the Financial Accounting Standards Board. Official positions of the FASB Board are arrived at only after extensive due process and deliberations.

Hello and welcome...It’s a great honor to be speaking here today. For many years, I’ve watched with envy the many prominent people that have spoken at the National Press Club. The envy related not only to being able to appear at such a prestigious venue, but also to being awarded the coveted NPC coffee mug.

By most measures, the past two years have been a very difficult and challenging period for virtually everyone. As we continue to examine the causes of the global financial crisis, many important lessons are emerging—lessons for all of us in the capital markets—lessons that challenge some of our core beliefs and operating principles. History does not repeat itself—people repeat history. So hopefully the lessons learned will help us build a sounder, stronger financial system.

There is a general consensus that excess leverage at many levels and lax lending practices fueled the creation of complex and risky structured securities and derivatives that were spread across opaque and unregulated markets around the world. When the risks became evident, the lack of basic supporting infrastructures in terms of timely and accurate information flows, clearing mechanisms, and price discovery compounded the problems, leading to freezing credit markets, plummeting equity markets, and significant downward pressure on economic growth.

However, one very welcome development arising from the financial crisis is that a much broader constituency is calling for greater transparency as a necessary ingredient for recovery and the rebuilding of investor and public confidence. Included in this has been the need to improve and strengthen certain accounting and reporting standards. While accounting did not cause the crisis and accounting will not end it, it did reveal a number of areas requiring improvement in standards and overall transparency. And so, over the past 18 months we have responded vigorously with a number of new standards and enhanced disclosure requirements relating to securitizations and special purpose entities, credit default swaps and derivatives, financial guarantee insurance, and fair value measurements and credit exposures.

Unfortunately, there have been certain major companies—including ones that subsequently failed and had to be rescued by the government—and industry trade groups that have sought political intervention into accounting standard setting. While that is their right, and while we certainly welcome active dialogue with lawmakers, politicization of accounting standard setting by special interests risks undermining public confidence in the integrity of financial reporting. The investing public expects and deserves unbiased and transparent financial information that is not skewed to favor particular transactions, companies or industries. We work hard to meet that expectation, trying to be very open, thorough, objective, and timely in responding to reporting issues that arise in a very challenging environment.

Transparency is not just a buzz word or a cliché. It is a fundamental and absolutely essential attribute of sound financial markets. Relevant, trustworthy, and timely information is the oxygen of financial markets. Depriving markets of such information—or polluting the information—can have very adverse consequences.

And so additional systemic actions by others are also needed to improve disclosures and transparency at other levels—particularly those relating to the complexities and risks inherent in financial products, and to the information systems around the markets for structured securities and derivatives. Transparency to the American public around taxpayer funded investments and financial support of major U.S. companies is also essential.

Last week the Administration issued their plan for financial and regulatory reform. The GOP has also released a proposal on regulatory reform. Various private sector groups have also issued lengthy studies with detailed recommendations on changes to our financial and regulatory systems. Congress has begun discussing these and other proposals for change.

While I may not be positioned to offer an overall blueprint for regulatory reform, I have some strong views on this subject, formed from observing and participating in the events of the past few years, and a career dedicated to the improved functioning of capital markets through the enhanced quality of information provided to investors.

Accordingly, I would like to provide my thoughts on some key objectives and principles that should guide the reforms. I do so without any pretense that these are the only or the most critical matters that need to be addressed. But I hope that my thoughts will be useful in evaluating the many detailed proposals now emerging on reform of our financial and regulatory systems. And I will comment on the relationship between these matters and our role and activities as the nation's accounting standard setter for public and private companies and not-for-profit entities.

As we address and evaluate potential reforms, we need to strike the right balance—between regulation that's respected and that effectively recognizes and manages risks—and regulation that fosters sound economic growth and competitiveness and that lets those that fail—fail!

This crisis is also teaching us that it's not just about the US economy and our challenges here at home. Over the last two decades, we've witnessed the emergence of a global economy and the recent crisis has painfully demonstrated that national markets and economies are now inexorably linked and interdependent.

So as we look to the future, we must both get our own house in order and ensure that we actively participate in the development of global financial and regulatory mechanisms.

My thinking on these matters has benefited greatly from the many discussions I and fellow FASB members have had with our advisory groups and other parties. In particular, the discussions at our Financial Crisis Advisory Group over the past five months have provided us with some excellent insights.

The FCAG, as we affectionately call it, consists of senior leaders from the investment, financial services, and regulatory communities around the world and has been advising the International Accounting Standards Board (IASB) and us on financial reporting and regulatory issues emanating from the financial crisis.

I believe that the primary objective of any redesign of our financial and regulatory systems should not only be to avoid a repeat of the financial crises of the past 20 years, but also to create a solid platform for sound and stable economic growth through an effectively functioning financial system that deserves and maintains public trust and confidence in our capitalist system and way of life.

While that may sound rather grandiose and vague, isn't that what financial institutions, capital markets, and financial regulation are all about—to promote and protect our economic well-being and those of future generations? Sustaining public support for our way of life, including the many freedoms we enjoy, depends on people believing that our system offers the promise of a bright future. Investors seeking to build wealth to fund the increasing costs of healthcare and college tuition and to provide retirement security cannot have their nest eggs broken and scrambled every six or seven years. Reform of our financial and regulatory systems is part of rebuilding and maintaining a healthy economy and a bright future. In the parlance of politics, “it’s all about the economy, stupid!”

That’s the easy part. Now let’s look at some key principles that I believe are important components in any redesign of our financial and regulatory systems. As I have already noted, transparency is certainly one of those key principles. But there are other related ones.

First, we must clearly acknowledge the need to have proper infrastructures supporting financial markets. Without infrastructures to facilitate the timely flow of relevant and reliable information that enable informed decisions, ready price discovery and effective clearing mechanisms, markets can become dysfunctional. Effective regulation, oversight and enforcement are also key ingredients of sound markets, as is the appropriate exercise of due diligence by investors and proper risk management by financial institutions.

While this may all seem obvious, it was precisely the absence of many of these basic features from rapidly growing segments of the credit and derivatives markets that were at the heart of the U.S. credit crisis that then broadened into a global financial and economic crisis. The problems and chain of value-destruction are well chronicled and with the benefit of hindsight, we can now see problems and failures across the whole chain, including the exploitation of regulatory gaps at many levels and the failure of regulators, rating agencies, leaders of financial institutions, investors, and others to appreciate the risks.

Unfortunately, balkanized regulatory systems, both in the U.S. and across international financial markets, coupled with a deregulatory philosophy by key policymakers may have made it difficult, if not impossible, to rein in the inherently unsound practices and overall exuberance driving these activities. Once the risks became more evident and the music stopped, the sheer complexity of many structured credit products and derivatives coupled with the lack of clearing mechanisms, visible price discovery, and standardized information on these instruments compounded the problems. The result was not only the freezing of credit markets, but also a loss of public trust and confidence in financial institutions, in capital markets, and in our economy.

In short, we cannot again allow huge, unregulated and opaque financial markets. In modern times, the proper operation of capitalism depends on the appropriate regulation of institutions, of financial products, and of market participants and on the existence of infrastructures that support transparency and the smooth functioning of markets. Far from constraining markets and capitalism, these are essential elements in its effective operation and in public trust in the system.

In my world, that of accounting and independent accounting standard setting, the absence of these elements makes our task very challenging. I don't believe in blaming others, but I'd like to set the scene for some of my observations. Some of the most difficult accounting and reporting issues emanating from the financial crisis stem, at least in part, from the lack of proper regulation and risk management, unsound lending and securitization practices, and the absence of proper market infrastructures around the "dark markets" for structured credit products and derivatives.

Under such conditions, accounting and valuation are significantly challenged. Proper accounting and valuation require that companies and market participants identify, understand, and reasonably calibrate risks and returns emanating from financial assets and obligations, and be able to readily ascertain transaction prices in exchange markets.

Thus, it is not surprising that many of the issues we have had to address over the past eighteen months surround the determination of fair values in inactive and dislocated markets, the recognition of impairments of financial assets in such markets, accounting for securitizations and the use of off-balance sheet entities by certain major financial institutions, and the quality and timeliness of disclosures of risks.

The financial crisis has also highlighted a number of relationships of public policy importance between accounting standards and financial reporting to investors, on the one hand, and regulatory reporting by banks and regulatory policy by bank regulators, on the other hand.

Both impact on financial institutions and both are vital to the effective operation of the financial system and the economy. But there seems to be some confusion in the media and elsewhere about the relationship between the accounting standards we set and regulatory capital. We do not determine regulatory capital. The bank regulators do. However, under laws enacted by Congress in the wake of the S&L crisis, the determination of regulatory capital by the bank regulators starts with the GAAP numbers. But the bank regulators have some discretion to adjust the GAAP figures and they also have other tools to address capital adequacy, liquidity issues, and concentrations of risk at regulated institutions.

So the regulators have a natural interest in the accounting standards we set. Likewise, investors have an interest both in our standards and in the impacts of regulatory requirements and actions on the institutions in which they invest. In that regard, I commend the Fed and the other U.S. bank regulators on the transparency they provided on the results of the recent “stress tests” of major bank holding companies.

Certainly, whether as depositors, as investors, as business people, or as citizens of this great country, we all share a deep interest in the strength and stability of the financial system and the economy. But the public policy missions and focus of accounting standard setting and prudential regulation in helping achieve these goals are different. Our focus as accounting standard setters is on the communication of relevant, transparent, and unbiased financial information on corporate performance and financial condition to investors and the capital markets. That information is aimed at facilitating informed investment decisions and is essential to effective allocation of capital across the economy. The transparency provided by external financial reports also contributes to financial stability by reducing the level of uncertainty in the system. On the other hand, the very important focus of bank regulators is on the safety and soundness of individual financial institutions, protection of customer deposits, and on the overall stability of the financial system.

Given our different missions and focus, it is not surprising that we would sometimes have different perspectives on particular accounting and reporting matters affecting financial institutions. For example, bank regulators and the institutions they regulate may be less enthusiastic about the use of fair value measurements because of concerns over potential procyclical effects, volatility in reporting, and impacts on regulatory capital, while standard setters and investors view such information as important in understanding and evaluating the financial condition, risks, and performance of these institutions. Indeed, studies of past market and credit crises have indicated the need for better risk management by financial institutions and the importance of fair value information in fostering that objective.

Despite the differences in mission and focus, my experience is that by working together and sharing perspectives, we can often find common ground and develop common reporting solutions that meet the needs of the regulators while preserving the integrity of reporting to investors. But in some cases, a single accounting or reporting treatment may not properly achieve the objectives of both the regulators and reporting to investors and the capital markets.

In such cases, transparency on the different treatments is important. Moreover, it is not appropriate to subordinate or subvert external reporting to investors to the needs of the regulators or vice versa. Both are essential public policy goals in ensuring the proper functioning of the financial system and the economy. Therefore, preserving and clearly delineating the separate public policy missions of securities regulators and accounting standard setters in terms of investor protection and transparency and that of financial institution regulators in terms of safety and soundness and financial stability are, in my view, important in any regulatory reform.

The goal should be to promote a close working bond, while ensuring that transparency and sound reporting to investors and the capital markets are not subordinated to the objectives of financial institution regulators and that the regulators are not inappropriately handcuffed by requirements that they conform their treatments to GAAP. Accordingly, I would be supportive of a greater decoupling between the determination of bank regulatory capital and our standards.

My next principle is that any reforms of our financial and regulatory system must be perceived by the public as substantive, as balanced, and as producing fair and equitable outcomes. They must promote public confidence in the proper functioning of and fair dealing in our capital markets and in the overall health and stability of our financial and economic system. They must also be perceived as balanced. On the one hand, they must not stifle innovation and appropriate risk taking. But, on the other hand, I also believe that the reforms need to convince the American public that we have taken the steps necessary to move beyond the one-way capitalism, the "heads I win, tails everybody else loses" mind-sets and practices that have, quite rightly in my view, sparked widespread outrage. So while the taxpayer-funded bailouts of major financial institutions and other major corporations were necessary to avert deeper harm to the economy and our society and to begin to get us out of the ditch, the "too big to fail" phenomenon is clearly fraught with danger and is perceived by many as downright unfair. Accordingly, reforms of our system must have an eye to avoiding, or at least, reducing the incidence of this in the future.

And there have been similar issues associated with excessive executive compensation not tied to performance. Perverse incentives seemed to motivate the leaders of certain major financial institutions to adopt what we now know were high risk strategies in an apparent quest for a big corporate, and perhaps, personal, payday. There are many excellent CEOs of U.S. corporations and I think few object to Bill Gates or Warren Buffett being worth billions, because they 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 or she was in charge and then, after running the company into the ground, is given another $50 million to leave. In the past, when I voiced this point of view, some called me crazy and anti-capitalist. To the contrary, my concern has been that these practices were eating away at the fabric of our capitalist society.

I am therefore heartened that there now seems to be more widespread recognition of this problem. Don’t get me wrong, I am not in favor of the government setting and enforcing specific pay levels or pay limits in the private sector. But the investing public needs to see that the private sector is effectively addressing this issue either through continued improvements in transparency and corporate governance around executive compensation or by other means. I fully recognize that this is a controversial and complex issue and that developing fair and balanced solutions in this area will not be easy. But again, the principle I believe in strongly is that our financial system, our capital markets, and regulation must be perceived by the public as leading to fair and equitable outcomes. Success should be rewarded. Failure should not.

My third set of principles relates to our ability to operate successfully on the global stage. This crisis has been global in scale and clearly demonstrated the many linkages between financial markets and economies around the world. It has also revealed the problems that can result from regulatory gaps and differences in regulation across international financial markets. Resolving these problems and preventing them from happening again requires active coordination of financial market regulation across the major capital markets of the world. So while the prospect of having a single global capital markets regulator or a single set of regulatory rules across the international capital markets is not, in my view, a realistic prospect in the foreseeable future, much can be achieved through continued focus by groups such as the G20, the International Organization of Securities Commissions, the Basel Committee and the Financial Stability Board to develop solutions to regulatory problems in global financial markets.

In that regard, the U.S. continues, at least for the foreseeable future, to be the single largest national economy in the world and we have the largest capital market in the world. Our actions, our financial and regulatory missteps, and our economic well-being have significant impacts on the rest of the world. While the credit crisis may have originated in the U.S., the shock waves reverberated around the globe. So it’s not surprising that while some accused China of exporting toxic toys—we have been accused by some of our foreign partners of exporting toxic securities. Unfortunately, there is some truth to this accusation and now, after having seen the S&L crisis, the dot.com bubble, and the U.S. induced global financial crisis, some of our foreign colleagues are understandably questioning our ability to run sound capital markets and a reliable financial and regulatory system.

We need to take these concerns very seriously. The United States capital markets and our financial system have been and must continue to be one of our crown jewels. We can’t risk a sustained loss of confidence in them, either at home or abroad. The good news is that as a country we are generally quick to recognize and address these types of problems and the strong actions by the Administration, by the Fed, and by Congress to shore up our financial system and to revive economic growth have, I believe, signaled to the rest of the world our commitment to act forcefully in the face of crisis.

While our actions and our economic well-being significantly impact the global economy and the international financial system, we are no longer the sole dominant or controlling party. Accordingly, we have the dual challenge and responsibility in the global context of both ensuring the health and vitality of our capital markets and economy, not only for our benefit, but also for the sake of the rest of the world, while also being an active and constructive participant in developing and supporting global financial and regulatory solutions and mechanisms. We need to be both credible and persuasive, seeking to inject the good aspects of our DNA into global efforts where appropriate, while also being careful to avoid trying to dictate to the rest of the world or seeking to replicate the less sound and outdated aspects of our system in global designs. Thus, we must “ride two horses,” taking care of business at home, while also working with international colleagues both as leaders and as good citizens of the world in advancing global agendas.

This is precisely what we at the FASB have been doing in terms of the world of accounting standard setting. Recognizing the potential benefits that could result from having a single set of high-quality accounting standards across the global capital markets, we have devoted substantial time and effort in recent years to working with the International Accounting Standards Board on jointly improving and converging our respective standards through developing common standards in major areas and eliminating differences between our standards.

At the same time, we also strive to take care of business at home by responding on a timely basis to reporting issues in our system. Riding these two horses is not always easy and sometimes requires timely actions in terms of improving U.S. GAAP in an area while also working on longer term global solutions with the IASB in the same area.

So those are my views in terms of major objectives and principles on reform of our financial and regulatory systems. To recap, I believe significant reforms are needed. They should have as their primary objective building a solid and sustainable platform for sound and stable economic growth through properly functioning financial markets that maintain public confidence in our system and our way of life. The reforms should be guided by key principles relating to transparency, to ensuring proper infrastructures supporting the markets, to promoting outcomes that are widely perceived as balanced, fair and equitable, and to operating in the global context.

Again, let me emphasize that while I view the thoughts I've offered today as very important themes that should be borne in mind in regulatory reform, I am not asserting that these are the only critical matters that need to be addressed.

Certainly, there are lots of opportunities for positive change.

I am an eternal optimist and believe that we are up to task, as challenging as it clearly will be. Thank you, and now I'll be happy to take questions.