Systemic Risks and Problems in World Financial Markets
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End of Speech

The time is now, I suggest, again for a "Special Study," under oath, with subpoena power, conducted independently, reporting directly to Congress, with such commentary by the Federal

Reserve, Treasury, Comptroller of the Currency, SEC, CFTC, and anyone else who would like to comment on the ultimate analyses and conclusions of the Study.

The Chairman of the SEC and Chairwoman-Designate of the CFTC should designate a Director of the Study and then let that Director staff the Study -- with subpoena power. We will not find out how the markets really work without such a Study. Why subpoena power? Let me remind you that at the time of the Salomon Brothers scandal almost three years ago, no securities firm would voluntarily testify about their operations in the REPO and government securities market. Nor will they do so fully and frankly about derivatives in response to a letter from the Secretary of Treasury, or the Chairman of the Federal Reserve, or the Chairman of the SEC or FTC.

They will under oath. And that is the way to develop a body of knowledge in this particular area. The alternative is to rely on Grand Juries, SEC investigations after the fact, class action lawsuits against directors, and surveys. That is not a way to make wise public policy.

Permit me to summarize and pull some of this together.

As profitability has eroded in traditional lines of protected businesses for all of the reasons I have noted, there has been a seriatim of problems: REITs; junk bonds; capitalization of interest; huge losses on complex derivative products; an S&L crisis in the U.S. As each problem dissipates with a lot of damage in its wake, firms have sought yet another profit center: a controlled repo market, the use of equity derivatives, foreign exchange speculation to test

whether a government can match the strength of the private sector, structured finance -- an arcane derivative. All of that makes it difficult, to say the least, for governments to allocate resources and make economic policy. This, of course, some would argue, is an appropriate constraint. Let the private sector decide. But, I would repeat, those intermediaries are also acting -- some of them -- most -- with direct government explicit backing.

That now brings me to some final points which, because of time constraints, I can only briefly note here -- what do governments, worldwide, worry about. What are the choices and dilemmas they face?

- How to encourage banks to be prudent about lending without constraining their lending. The U.S. is a good example. The banking excesses and the warnings from the authorities have "cooled" bank lending -- perhaps too much given the state of the economy. Increased capital requirements designed to protect the taxpayer inexorably have reduced credit extension. Once burned, twice shy.

- How to maintain an adversarial and supportive relationship with financial institutions, particularly in the context of institutions who may be acting in ways inconsistent with national policy in, say, FX trading, given the unique relationships between banks and government.

- How to control banks who set up subsidiary activities offshore where there are few

supervisory or regulatory controls and where, as a practical matter, any losses will be borne by the parent and its insured depositors.

- How to become informed, and set what kind of requirements for derivative products -- across countries and different kinds of financial institutions. Why debate about jurisdiction or whether a particular instrument is or is not a security. What precisely do we intend to do to regulate, and how, once the label is attached. And the answer is not "Aha, if a security, then the anti-fraud provisions apply." So?

- How to mark assets to market without destroying confidence in the banking or insurance industries.

- How to control, or whether to control, the credit-extending activities of securities firms -- particularly in areas which directly affect national monetary policy.

- How to create an environment for banking institutions and securities firms which is conducive to profitability when there are so many financial intermediaries and products worldwide competing for the same customer base. Sooner, not later, they will get in trouble as the need for risk taking increases an attempt to derive profit in a competitive environment.

- Governments are concerned about the domino syndrome. Too many intermediaries, too

many non-creditworthy borrowers, too much expertise outside of government, too many loopholes, too much leverage. Too much off-balance sheet.

- How to adjust interest rates to be sector-specific; say, to apply only to FX speculation. The freedom to move currencies across countries means exchange rate stability will be difficult to establish. Moreover, transactions are done routinely outside the U.S. which, in the U.S., would result in severe criminal penalties. It is not a market which would survive careful scrutiny, say, by the SEC, without resulting in criminal indictments.

These are not easy problems to handle. Their "resolution" would require an international consensus which does not now exist. It also would involve a resolution of competing and divergent principles of regulation and control both within and across countries. Private sector management clearly needs to be better informed, as do governments and Central Banks, about the intricacies of market products. But, fundamentally, that intricate knowledge is not now in the hands of policy makers. It should be. That's why a "Special Study" is long overdue.

Thank you.