U.S. DEPARTMENT OF THE TREASURY

Remarks by Treasury Secretary Tim Geithner on the State of Financial Reform

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As Prepared for Delivery

I want to use the occasion of this week’s Financial Stability Oversight Council meeting to review the progress made on financial reform to date and to outline our priorities and challenges for the year ahead. I am providing this assessment in my capacity as Chair of the Council, but do not speak for its individual members.

This is a critical year for financial reform. In 2012, we expect to put in place key elements of the new framework of safeguards for the financial system. And we expect this year to make progress building the foundations of reforms to the housing finance system.

Much of the basic framework of these reforms is already in effect. New global agreements to limit leverage have been reached. The FDIC has finalized rules for managing the failure of a large firm. The CFPB is up and running and providing better disclosure for consumers. We are deploying new authority and greater enforcement resources on a more coordinated basis to go after fraud and abuse. The majority of the new safeguards for derivatives markets have been proposed.

The financial system is getting stronger and safer. Much of the excess risk- taking and careless and damaging financial practices that caused so much damage have been forced out of the financial system. These gains will erode over time if we are not able to put our full reforms into place.

These are tough reforms, and we have forced a necessary and fundamental restructuring of the financial system. But even with these changes, and even with the remaining damage caused by the financial crisis, our financial system is once again helping support economic growth by meeting the growing demand for credit and capital at lower cost.

We still have a lot of hard and complicated work ahead of us.

Today, I want to review the progress so far and challenges ahead this year.

The State of Financial Reform

First, banks now face a much tougher set of limits on how much risk they can take. New rules on capital and liquidity will limit leverage by requiring banks to hold more financial reserves against risk and to fund themselves more conservatively. These new safeguards are critical to reducing the risk of large financial failures and limiting the damage those failures can cause to the broader economy. In 2012, we will focus on defining the new liquidity standards and on making sure that capital risk-weights are applied consistently.

These new safeguards are tougher on the largest banks than they are on the rest of the banks that make up our banking system, recognizing that community banks pose a much smaller risk to the broader economy. These reforms are being complemented by other safeguards to limit risk-taking, such as the Volcker Rule and a new limit on the size of firms and the concentration of the financial system. And the core constraints on leverage will apply not just to banks, but also to other large financial institutions that could pose a threat to the stability of the financial system. This year, the Council will make the first of these designations.

Second, the derivatives markets, for the first time, are coming under a comprehensive framework of transparency requirements, margin rules, and other safeguards. These reforms, the balance of which will be outlined this year, are designed to move standardized contracts to clearing houses and trading platforms, which should lower costs to those who use these products. They are complemented with more conservative safeguards applied to the more complex and specialized products that are less amenable to central clearing and electronic trading. These reforms will help preserve the economic benefits of allowing businesses, farmers, and investors to hedge against risk, while limiting the potential for abuse.

Third, we are putting in place a carefully designed new set of safeguards against risk outside the banking system and enhanced protections for the basic “infrastructure” or plumbing of the financial markets:

· Money market funds will face new requirements designed to limit their vulnerability to “runs” like the one that took place in 2008, with the SEC planning to propose significant reforms this year.

· Important funding markets like the tri-party repo market are now more conservatively structured.

· International trade repositories are being developed for derivatives, including credit default swaps.

· Designated financial market utilities will be subject to comprehensive oversight and required to hold stronger financial cushions against risk.

Fourth, we now have a much stronger set of protections in place against the “too big to fail” problem, which is the concern that large firms, having been rescued in this crisis, will take too much risk in the future in the expectation that taxpayers will protect them from failure.

The key elements of this strategy are:

· Capital and liquidity rules that impose much tougher limits on leverage by the largest firms to both reduce the probability of failure and strengthen their ability to withstand the pressures of other institutions’ failures;

· New protections for derivatives, funding markets, and for the market infrastructure that together will help limit contagion across the financial system;

· Tougher limits on size, which will prevent the largest banks from becoming too large relative to the size of the financial system.

· And a bankruptcy-type framework to manage the failure of large financial firms, which in the United States we call “resolution authority,” that prohibits bailouts for private investors, protects the taxpayer, and forces the financial system to bear the costs of future crisis.

Fifth, we are putting in place significantly stronger protections for investors and consumers.
We have established a dedicated agency to enforce new consumer protections. The Consumer Financial Protection Bureau has already taken important steps to carry out its mission, such as working to improve disclosure on mortgages and credit cards, including consolidation of the two required mortgage disclosure forms into one, and developing new standards for a qualified mortgage. Consumers are already relying on the CFPB to help settle disputes with financial companies, and the CFPB is making sure that all financial companies—from big banks to payday lenders—are playing by the same rules.
We are using new authorities to strengthen protections for investors, improve disclosure, and give shareholders a greater voice on issues like executive compensation.
The failure of customer account segregation rules to protect the customers of MF Global illustrates that we have some work to do ahead. Recently, the CFTC finalized rules to improve protections for certain customer funds. The Council, working with the SEC and the CFTC, will undertake a broad review of what other changes are necessary to strengthen these protections further.
We are making considerable progress in implementing reform. We are taking the time necessary to get the substance right, providing for extensive public comment and input, and working with the relevant agencies here and around the world to provide a common set of safeguards.
The direction of reform is clear, and as we finalize the remaining elements, we will be able to provide businesses, investors, and consumers with more clarity and certainty. Those who are still working to delay and weaken reforms will only increase uncertainty and damage our efforts to get the rest of the world to adopt a level playing field.

Priorities Ahead

As we move forward, we want to get the reforms right so that they will endure as the market evolves. We are trying to be careful to look not just at the individual rules in isolation, but also the way rules interact with each other and the broader economy. We want to be careful to get the balance right—building a more stable financial system, with better protections for consumers and investors, that allows for financial innovation in support of economic growth.

Here at home, we face an important level playing field challenge that results from the segmented nature of our supervisory and regulatory system.

We want to make sure that financial firms engaged in similar activity and financial instruments that have similar characteristics are treated roughly the same. This matters because small differences can have powerful effects in shifting risk to where the rules are softer. Where Congress has given the independent agencies the authority to align their rules, they should do so. And as regulators work to close the gaps in our system, they must work together to prevent new ones from forming.

Putting the unfinished elements of reform in place is important, not just to provide clarity and certainty to the markets, and not just to protect individuals and businesses from future financial crises, but also so that we can continue to help shape the global reforms that we need to provide a level playing field.

A Global Level Playing Field

Financial markets are global—more integrated than ever before. To protect our economy from risks that arise outside the United States and to provide a fair and level playing field for U.S. firms, we need a more level playing field globally.

This is particularly important in the reforms that toughen rules on capital, margin, liquidity, and leverage, as well as in the global derivatives markets. In these areas we are working to discourage other nations from applying softer rules to their institutions and to try to attract financial activity away from the U.S. market and U.S. institutions.

Among these challenges are aligning the developing derivative regimes around the world; preventing attempts to soften the national application of new capital rules; limiting the discretion available to national supervisors in enforcing the newly toughened risk-weights for capital; and designing the rules for resolution of large global financial institutions, in part to limit the competitive advantages enjoyed by non-U.S. banks in markets where governments have a stronger tradition and more authority to support their banks in conditions of stress.

And because in some areas U.S. reforms are tougher or just different from the rules forthcoming in other markets, we need to figure out a sensible way to apply those rules to the foreign operations of U.S. firms and the U.S. operations of foreign firms. This is very complicated and another example of where we need a clearly articulated common approach across the U.S. regulatory agencies.

Housing Finance Reform

We also want to make progress this year in building the foundation for reforms to the mortgage market in the United States, including a path for winding down the GSEs. In our white paper released last February, we outlined a broad strategy with several options for reforming the housing finance system. We expect to lay out more detail around approaches to reform in the spring, and we plan to begin exploring options for legislation more intensively with Chairmen Bachus and Johnson and Ranking Members Frank and Shelby.

As we made clear last year, our immediate obligation is to repair the damage to homeowners, the housing market, and neighborhoods caused by the crisis. Yesterday, the President spoke about the range of tools we're utilizing to this end, including broad-based refinancing for responsible homeowners; putting forward a single set of standards to fix the mortgage servicing system; and, in conjunction with the FHFA, the conversion of foreclosed homes into rental properties.

As we tackle these challenges, we will work towards comprehensive reform to create a more sustainable housing finance system. Our plan will wind down the GSEs and bring private capital back into the market, reducing the government's direct role in the housing market and better targeting our support towards first-time homebuyers and low- and moderate-income Americans.

We will also make sure that a new system fosters affordable rental options—close to good schools and good jobs; that it has stronger, clearer consumer protections; and that it creates a level playing field for all institutions participating in the housing finance system.

For this to happen without hurting the broader economic recovery and adding further damage to those parts of the country hardest hit by the crisis, we need to get banks and private investors to come back into the market on a larger scale. This cannot happen without more clarity on the rules that will apply, so we want to move forward using the authority we have and to pull forward the prospects for broader legislation to replace the GSEs and reform the rest of the market.

Credit Availability

We continue to work to expand the availability of credit to those parts of the financial system where businesses and individuals still find it hard to borrow. Although across the economy as a whole bank lending is rising, credit terms have eased, and the cost of credit is relatively low, there are pockets where credit is tighter than it needs to be, including mortgage finance and small business.

We have a broad array of programs in place to help improve access to credit and capital for small businesses. As just one example, banks participating in the Small Business Lending Fund have increased their small businesses lending by $3.5 billion, a 10 percent increase over baseline levels, over the past several months.
There are also promising bipartisan efforts in Congress to improve small businesses' ability to access equity capital, in both the private and public markets. Earlier this week, the President sent his Startup America Legislative Agenda to Congress to help move this process along. As conditions improve, it is important that we remain focused on making sure that small businesses, a crucial engine of job growth, have continued access to equity capital and credit.
In the housing market, many Americans trying to buy a home or refinance their mortgage are finding it hard to do so, even for FHA- or GSE-backed mortgages. We have been working closely with the FHA and FHFA to encourage them to take additional measures to remove unnecessary barriers. They are making progress, and we expect those two agencies to be in a position to outline additional reforms in the coming weeks.

More broadly, it is important that bank supervisors, in the normal conduct of bank exams and supervision, as well as in the design of new rules to limit risk taking and abuse, are careful not to overdo it with actions that cause undue damage to the availability of credit or liquidity to markets.

Progress Toward A Stronger Financial System

I want to conclude by emphasizing that the U.S. financial system is getting stronger, and is now significantly stronger than it was before the crisis.

· We forced the largest firms to raise a substantial amount of new capital, to reduce the size and scope of their businesses where that was necessary, and to build stronger cushions of liquidity. We moved quickly to wean the financial system off the emergency programs we were forced to put in place in the crisis to protect the economy from broader financial collapse. Banks have increased common equity by more than $350 billion since 2009.

· We have shut down or restructured the weakest parts of our system that played a central role in the crisis. Banks and other financial institutions with more than $5 trillion in assets at the end of 2007 have been shut down, acquired, or restructured. The asset-backed commercial paper market has shrunk by 70 percent since its peak in 2007, and the tri-party repo market and prime money market funds have shrunk by 40 percent and 33 percent respectively since their 2008 peaks.

· Finally, we have been able to dramatically reduce the expected costs of the financial rescue to levels that were unthinkable in early 2009. The financial assistance we provided to banks through TARP, for example, will result in taxpayer gains of approximately $20 billion.

The stronger position of banks is helping to support broader economic growth, including the more than 3 million private sector jobs created over 22 straight months, and the 30 percent increase in private investment in equipment and software. Broadly, the cost of credit has fallen significantly since late 2008 and early 2009. Banks are lending more, with commercial and industrial loans to businesses up by an annual rate of more than 10 percent over the past six months.
No financial system is invulnerable to crisis, and we still have a lot of unfinished business on the path of reform. But the American financial system is now much less vulnerable than it was and is now able to help finance a growing economy, rather than being a drag on overall economic growth.
These are tough reforms. They are tough where they need to be tough. But they will leave our financial system safer, better able to help businesses raise capital, and better able to help families finance safely the purchase of a house or a car, to borrow to invest in a college education, or to save for retirement. And they will protect the taxpayer from having to pay the price of future crisis.