

Remarks by  
E. Gerald Corrigan  
Managing Director  
Goldman, Sachs & Co.

At  
**Conference in Memory of Tommaso Padoa-Schioppa**  
Banca d'Italia  
Rome, Italy  
December 16, 2011

Good morning ladies and gentlemen. Following the examples of those who have preceded me on today's program, I want to begin with a few observations about Tommaso Padoa-Schioppa. Tommaso and I had a great deal in common. He began his highly distinguished career at the Banca d'Italia in 1968 – the same year I joined the New York Fed. Early on in our careers as central bankers we both developed a passionate curiosity about the workings of payment and settlement systems. Each of us came to view financial stability, along side price stability, as the inherent goals of central bank monetary policy. Tommaso and I also served as chairs of the Basel Committee on Banking Supervision in the 1990's. Later, we worked together on a number of critical accounting policy issues and their implications for financial stability.

I could go on at great length about Tommaso's legendary achievements as a scholar and economic visionary, but I would rather end these remarks with a few words about the human side of Tommaso. He was truly a kind and gentle man. He cared deeply about the well being of people – especially the less fortunate among us. He had an engaging and ever present smile and a twinkle in his eye especially when still another innovative idea or concept occurred to his always inquisitive mind. For Tommaso, differences of professional judgment among scholars and policy makers were always in cordial, respectful and understated. In short, Tommaso's

quiet leadership and his sense of what was right and proper for its own sake were the visible traits of a great man and an even greater colleague and friend.

My purpose today is to share with you some thoughts and observations on a profoundly complex and vitally important question; namely, as we look ahead five years from now and almost ten years after the darkest days of the financial crisis – will the probabilities of major and systemic financial shocks have been dramatically reduced in a setting of a more stable and more efficient system of global financial intermediation?

In seeking to answer that question we must keep in mind that the dual goals of greater stability and greater efficiency are a “package deal” in that it is very difficult to imagine how we can achieve either one of these goals without simultaneously achieving the other. Indeed, if we fail, the consequences of that failure will almost surely be reflected in adverse prospects for economic growth and employment.

Because so much is on the line, allow me to begin by answering my own question. In short, I believe that the prospects of achieving those dual goals are within reach but such an outcome is far from certain. I say that in part because the goals are so ambitious but also because many countries here in Europe and in the United States are faced with sub-par economic growth and

strong headwinds in the form of outsized budget deficits and high and rising debt ratios. Indeed, in many respects, the sovereign debt crisis in Europe is an extension of the excesses and distortions of the forces that gave rise to the events of 2007 and 2008.

In these circumstances, the premium on national and international efforts to press ahead with well conceived and well executed financial reform assumes enormous importance. The subject matter and the scale of the reform effort are so vast – and have so many moving parts -- that I believe we have no realistic choice but to focus particular attention on four high priority reforms that – in my judgment – constitute the necessary conditions for success. In essence, I am suggesting that if we do not get the design and execution of these four priority reforms right, even a high degree of success with the other items on the reform agenda will not be sufficient to achieve the goals of enhanced financial stability and efficiency. In the worst case, failure could actually result in greater instability.

The four necessary conditions for success are as follows:

First: Strengthened Capital and Liquidity Standards

- With regard to capital, the Basel Committee has made substantial progress in framing the Basel III capital standards including a multi-year plan for the

phase-in of the new rules. While some important issues remain to be resolved (e.g. the concept of a capital “add on” for so called systemically important institutions and insuring broad consistency in the calculation of risk weighted asset numbers) the market place is already treating the Basel III capital standards as an accomplished fact with here and now focus on how firms’ capital positions stand today relative to the future standards.

- Most observers – including myself – view the increases in the amount of capital and especially the quality of capital as contemplated by the Basel Committee as an important step in the direction of greater financial stability.
  
- While a cross border framework for capital adequacy has been a reality since the mid 1980’s, international standards for liquidity adequacy are a new – and long overdue – phenomenon. That is, the financial crisis forcefully illustrated that impaired liquidity, (particularly in the form of an electronic “run on the bank”) is almost always the proximate cause of the demise of seriously troubled financial institutions.

- It is critically important that the emergence of more rigorous capital and liquidity standards be treated by supervisors and practitioners as a single discipline. Financial history is crystal clear; it is the interplay between capital and liquidity that is at the center of our quest for greater financial stability.
  
- The Basel Committee, the Financial Stability Board and national supervisors have made great progress in designing new capital and liquidity standards but it is still far from clear how the remaining points of controversy regarding Basel III will be resolved and even less clear as to the timing and other details of execution will be sorted out.

### Second: Managing Very Low Probability Contingencies (Living Wills)

In the aftermath of the crisis there is broad agreement in principle that the authorities – working with the private sector – must find credible approaches to essentially eliminate the “too big to fail” problem. Conceptually, this issue involves the very complex task of how a seriously troubled financial institution and its supervisors will respond to extreme contingencies in order to identify a family of concrete steps that can be taken to either stabilize the troubled institution or wind it down in an orderly fashion. The term that is

widely used to describe this concept is living wills although I, for one, rather dislike that term in this context. Keeping in mind that rarely – if ever – have we witnessed the successful orderly wind down of systemically important financial institution – especially such an institution with an international footprint – the design and execution of such policies and practices is – to put it mildly – a very formidable task.

The concept of living wills has been discussed and debated at great length over the past two years. At this juncture, I want to acknowledge that meaningful progress is being made in the design of workable approaches to the concept of living wills.

While acknowledging the progress that is being made, I must quickly add that we still have a long and hard road ahead to design – much less execute – the living will concept.

As an example, at systemically important institutions, risk monitoring and management takes place – as it should – largely on a fully consolidated basis. In contrast, for purposes of living wills, the analysis of alternative contingencies and action steps is often based on legal entities, including legal entities located in multiple jurisdictions worldwide.

That being the case, the concept of “ring-fencing” such legal entities has much support in regulatory and political circles. Short of a truly global framework in such areas as bankruptcy laws, I remain uneasy as to whether ring-fencing will help or hinder the goal

of orderly wind-downs. As another example, orderly wind-down necessarily implies that at the point of wind-down the troubled institution and its supervisors must have in hand vast amounts of current and accurate information including, but in no way limited to, the following:

- Comprehensive and current data on all exposures to all counterparties and estimates of all such exposures from counterparties to the failing institution
- Valuations consistent with prevailing market conditions that are available across a substantially complete range of the firm's asset classes (including derivative and cash positions)
- Accurate and comprehensive information on a firm's liquidity and complete maturity profiles of its assets and liabilities
- Fully integrated, comprehensive risk management frameworks capable of assessing the market, credit and liquidity risks associated with the troubled institution
- Legal agreements and transaction documents that are available in an organized, accessible form such that cross default, close out rights, seniority claims, and other critical rights and obligations can be readily discerned

- Comprehensive information on the firm's positions with exchanges, clearing houses, custodians and other institutions that make up the financial system's infrastructure
- Comprehensive information on customer and client account balances held by the failing institution and its affiliates

As I said earlier, progress is being made in this area – more progress than I had anticipated – but this is an area in which we have little or no history or precedent. Thus, the risks of flawed design and execution remain very high.

### Third: Enhanced Resolution Authority

In the United States, Title II of the Dodd-Frank legislation provides the high level legal and regulatory road-map associated with enhanced resolution authority. For purposes of this discussion, the most important provisions of Dodd-Frank are those relating to the “orderly liquidation of covered financial companies.” In the legislation, a “covered” company is defined as “a systemically important institution.”

The trigger which activates Title II is an approval by the Secretary of the Treasury of a written recommendation from the Fed and the FDIC to appoint the FDIC as receiver for a systemically important institution that is in default or danger of default. Once Title II is

activated, the FDIC (in consultation with the Fed and the Treasury) is the agency responsible for the wind-down exercise. In discharging these responsibilities, the statute vests with the FDIC an important degree of flexibility including, in certain circumstances, the provision of funding to the failed institution if needed to preserve the continuity of systemically important operations.

While the linkage between living wills and enhanced resolution authority is clear, there is little or no precedent available to help guide the execution of living wills and orderly wind-downs of systemically important institutions having an international footprint.

To put this subject in further context, I should quickly add that the progress that has been made over the past two years in these endeavors is substantially greater than I once feared would be the case. However, even while acknowledging that progress, neither the design – much less the execution – of these untested policy tools are close to operational status.

In the meantime, the authorities and practitioners will continue to conduct stress tests, scenario analysis, and simulations in order to help capture the insights that will help fine-tune planning and execution of enhanced resolution authority. These tools and

techniques are helpful but based on my experience they can never capture the tensions and uncertainties associated with real time wind-downs when material surprises occur suddenly with alarming frequency. That, of course, is why the success of wind-downs and enhanced resolution authority will always depend not on abstract rules and regulations but on the experience, the judgment and the steady nerves of those responsible for the execution of these policies.

#### Fourth: Enhanced International Coordination and Cooperation

The international contagion effects of the crisis have dramatically strengthened the already strong case for enhanced international coordination and cooperation in economic and financial affairs with renewed emphasis on both crisis prevention and crisis management. These efforts are being spearheaded by the G-20, the IMF, the Financial Stability Board, the Basel Committee on Banking Supervision and a number of other international institutions.

In recent years, but especially in the immediate aftermath of the crisis, long overdue and largely successful efforts were made to broaden and deepen the countries which are engaged with these institutions particularly at a policy level.

While broader participation was necessary, the post crisis environment has not made it easier to achieve consensus much less agreement on economic, financial and regulatory policies. There are a number of reasons why consensus and agreement are more difficult to achieve including, (1) the subject matter has become more complex; (2) sovereign prerogatives loom more – not less – important; (3) the large number of people in the room or at the table; and (4) national economic and financial performance – especially in the industrial countries – is, at best, a mixed bag.

The silver linings behind the cloud of obstacles to the international cooperation process are that despite these obstacles (1) the crisis management efforts during 2007 and 2008 were an outstanding success; and (2) the leadership across all of these international institutions clearly recognize and are focused on the right issues and the right questions.

While success in forging financial reforms in these areas is a necessary condition for medium term gains in financial stability and efficiency, the risk profile of today's economic and financial environment is – in my judgment – every bit as troubling as it was in the fall of 2008. That adverse macro-economic and macro-financial risk profile is importantly driven by the European Sovereign Debt Crisis. In recent weeks and months, the authorities in Europe have had a measure of success in framing the broad architecture of a plan to contain and ultimately reverse

the debt crisis. While the plan is promising, important details remain vague such that the timing and execution of the plan is not clear. In these circumstances, financial markets remain fragile and the risk of a financial shock with highly complex contagion and systemic elements cannot be taken lightly.