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Address at the celebration of the 6th anniversary of the Hills Center for Governance at Yonsei University, Seoul

Tuesday, 28th April 2009

**“The World Economy after London G20: Recovery, Trade, Finance, and Governance”**

I would like to congratulate the commissioner and KDI on their presentation. As a typical lawyer, I was looking very hard for points to disagree with but I failed. The word regulation is there a lot more in their written statements than I prefer but nobody specifically endorsed any new rules.

I want to make four statements, very simple, very broad. I will do my best to defend them during our discussion. My basic effort is to attack the myth that says we need today a new regulatory international body to set standards on such matters as compensation levels.

**First:** In the United States, and elsewhere, bank regulatory personnel have had the complete authority and the complete responsibility to stop the fiscal crisis that we are now suffering. Before we do anything else we need to acknowledge that they failed. They did not do their job either because didn't have the skills to do it or they didn't have the resolve to do it. And I would say that most of them lacked the skills and many did not have the resolve.

Without the capacity or will to monitor risk, they sure did not have the capacity to manage the risk.

**Second:** we do have some ideas about what caused this crisis but there is not a complete consensus on that issue. We surely do not know enough about what's happening right now. and we don't know very much about what financial institutions will look like when this crisis is over; in my view it's not close to being over. So any new comprehensive reform effort is premature but I will get to that in a minute.

What happened? Well we all know that a whole lot of mortgages went unpaid and a whole lot of houses have been and are being soled at auction. Worldwide property values have plummeted.

The problem is that the really fancy programs (models) that they had to monitor risk did not work. Truly mathematical geniuses created things called “quants” that were supposed to coordinate a whole lot of different risks and tell the banks how to hedge against them. But as I said a combination of risks became so intense that the so-called risk model failed.

In simple terms the bank regulatory authorities and the risk managers in the banks did not understand that these “models” would not work. But as the Commission's report notes there were two dismal failures of corporate governance that seriously exacerbated the problem:

- Bank regulatory watchdogs and boards of directors allowed banks to adopt compensation policies that created incentives for the managers to take excessive risk. When bank CEO's decided that they were going to try to make a 20% return on equity they had to leverage enormously (and raise the attendant risk) in order to do that. If it becomes clear to CEO's they can make 10's of millions of dollars by taking more risk you can be certain that some will take the chance.

- The second failure of corporate governance is that corporate boards in far too many institutions did not sufficiently protect the independence and authority of risk managers who have not had the needed stature in their respective firms.

Another major factor contributing to our world wide fiscal crisis is the huge global fiscal imbalances that exist throughout the world. I was pleased to see it as the number one issue in the Commissioner's report: the great deficits in countries like the U.S. and the equally huge surpluses in the exporting countries: China and Germany for example. The problem of these imbalances may well pose a greater risk to the world economy than the recession we are now suffering. They constitute the "elephant on the other side of the mountain".

Last Saturday in Tokyo, at meeting with the Trilateral Commission, Jerry Corrigan, a former President of the Federal Reserve Bank of New York and currently an executive of Goldman Sachs stated "it is highly likely that these imbalances would create a serious macroeconomic problem even if we hadn't had the fiscal problem caused by the subprime mortgages". He argued that, in any event, the imbalances have made this problem much larger.

Whatever we may understand about how we got where we are I want to emphasize that again that we don't know enough about what's happening now. There is a debate about it. I'll just give you one example. John Taylor, a respected professor of economics at Stanford, and a former Undersecretary of our Treasury Department argues that the 180 billion dollars plus bailout of AIG was unnecessary. AIG, he says, could have gone through a normal bankruptcy proceeding without seriously affecting our economy. Peter Wallison, a scholar of the American enterprise institute, and former General Counsel of the Treasury Department agrees. And I read in the paper that Hank Greenberg, who created AIG thinks that AIG should have gone through bankruptcy. I don't know whether that's right. I just know that if you look around you will see a lot of disagreement as to what exactly is happening and what could happen. By no means do I mean to criticize the administration. They are acting boldly and strongly to try to deal with this issue, I'm only saying we don't know enough about our circumstances.

And this brings me to my **Third** point which is that the unknowns about where we have been are now and we will go are too great for us to undertake comprehensive reform of the whole international regulatory system. There is a, to me, a curious rush (the French as usual are at the head of it) to prevent the next crisis before we fix the one we're in. Just think about it. Until we find a way to train people that can monitor risk we can't manage risk. Until we fix that problem any system we adopt isn't going to work.

In short, the G20 had two things that should be their focus:

- Fix this crisis; and
- Attend to that elephant on the other side of the mountain: the global imbalances.

**Fourth:** What we do know can be the basis for serious incremental reform right now. My concern is that those who talk about a grand scheme of regulatory reform will ignore what can and should be done right now.

- We do need to authorise our central banks to secure more information about any accumulation of wealth in hedge funds and elsewhere. We just need to know more before we decide whether some regulatory action may be appropriate.
- We surely do need by specific legislation or by executive order to get a cadre of people who know how to monitor risk.

- We need to modernize the financial statement so that risk can be better understood. I agree with everything my colleagues here have said about accounting but I will go further. Our financial statements have for decades been obsolete. They were created in the days of bricks and mortar when assets were tangible. Auditors worked from the actual cost of assets. We now live in the age of intangibles and where people want current value. Such values are created by the estimates and assumptions of management. No matter how honest management may be there is a huge range in which those values can be fixed. Financial statements must be changed to make these ambiguities obvious. A few years ago the Economist Magazine in an article called “hard and fast is not fair and true” told us that we must to stop relying upon the “brittle illusion of accounting exactitude which tends to collapse in periods of economic strain.”
- Compensation policies of financial institutions need be changed so that they do not create incentives for excessive risk. They don’t need to be changed by government fiat. They need to be changed by creating independent compensation committees on corporate boards who will be given and take the responsibility for executive compensation.
- Also, there is a place today for an international body that will monitor the manner in which each country deals with its financial institutions. Best practices for risk monitoring and reporting can be agreed to.

But I close by saying again that this is not the time to create new and powerful regulators. For example our Secretary of the Treasury has proposed that a new “Systemic Regulator” be authorized to identify those firms that are likely to create the next systemic risk and to take whatever action may be necessary to protect them. Whether that kind of mothering would create super companies impervious to competition or destroy them by over regulation I cannot tell. What I can say is that the notion that we anyone may be able to predict the next systemic risk is beyond my understanding. Nobody could have predicted the financial havoc that a tiny British subsidiary of AIG has wrought on the world.

Thank you very much.