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97th Year

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Nightly Business Report - PBS

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Introduction

Chairman Barbara Hackman Franklin

Good afternoon everyone. I'm Barbara Hackman Franklin, Chairman of the Economic Club of New York, and it is my great pleasure to welcome all of you to the 377th Meeting in the 97th year of this club. We are especially pleased this afternoon to have as our guests of honor two leaders, new leaders, of New York's most important public financial institution. They are the new generation of financial leadership of our country – Tim Geithner of the Federal Reserve Bank and John Thain of the New York Stock Exchange. Both, I'm delighted to tell you, are members of this club. (Applause)

This is how our program will work. We'll first hear from our two guests of honor and then we'll turn to our usual question period and that will end at 1:35 and then your main course will be served. So let's get right to the program.

First, and we're doing this alphabetically, so Tim is first. Last fall, Timothy Geithner was named the 9th President and Chief Executive Officer of the Federal Reserve Bank of New York, and he succeeded our own Bill McDonough, former chairman of this club. In this role, Tim serves as a permanent member of the Federal Open Market Committee and that's the group we all watch very closely as they formulate U.S. monetary policy. He serves as vice chairman of that committee. Alan Greenspan is the chairman.

The New York Fed is the largest reserve bank and arguably the most important. It has a unique role. It's the only bank which conducts market operations to implement monetary policy and the only one to engage in foreign exchange market intervention to achieve our government's dollar exchange rate objectives.

Tim is ably qualified. He began his career at Kissinger Associates, then went to the U.S. Treasury where he rose rapidly through the ranks to become the first civil servant to be appointed Under-Secretary for International Affairs. He earned a reputation for skillful crisis management playing a key role in creating the financial packages that helped restore stability in Korea and Brazil. And subsequently, he was Director of Policy Development and Review at the International Monetary Fund, and then came to the Fed.

Tim is the eyes and ears of the Fed and Wall Street. We understand he used to speak a little Japanese, but he's agreed to speak to us today in English. I'm very pleased to welcome Tim Geithner, President of the Federal Reserve Bank of New York. (Applause)

Timothy F. Geithner

President and Chief Executive Officer

Federal Reserve Bank of New York

Thank you Barbara. It's great to be here. This is a terrific institution. It's nice to see so many familiar faces. And it's a great pleasure to be here with the distinguished and youthful John Thain as well. I work at a great institution, great in part because of my formidable predecessors, none more formidable than Bill McDonough standing here today. And I can tell you with confidence he's left a great institution with a terrifically strong capable dedicated group of individuals.

I want to talk a little bit today about the U.S. financial system at this point of transition in the U.S. economy. Our system today is currently enjoying a period of considerable strength. Financial institutions are strong. Innovation has spurred advances in risk management. Market practices in some core areas have been strengthened and the industry's payments and settlements infrastructure has been substantially improved. Our system has been remarkably resilient in the face of a range of recent shocks.

And this record is reassuring, but no financial system is without vulnerability, and periods of relatively favorable economic and financial conditions, such as those we are experiencing today, are a good time to reflect on the capacity of the system to withstand future stress. So I'm going to talk today a little bit about developments that have improved the overall stability of our system, but also about some continuing challenges, and on the implications of those challenges for risk management and for supervision.

The history of shocks to the U.S. financial system is highly varied. Even over just the past two decades, we have seen a range of systemic events with a wide diversity of sources and characteristics. We've seen credit booms and credit concentrations that resulted in substantial losses in the financial community. We have seen shocks reflected in sharp and substantial movements in interest rates, exchange rates, and asset prices.

Some of these events were associated with a deterioration in macroeconomic performance. Some of them occurred in periods of relatively strong economic performance. Some were driven by abrupt changes in expectations about inflation or about monetary policy. Often these events followed periods of accommodative financial conditions, rapid credit growth, sustained rises in asset prices, and low volatility.

Many of these events had a self-reinforcing element, with initial changes in interest rates or asset prices being amplified by the subsequent actions of market participants. Financial leverage was also an amplifying factor in many of these events. And in some instances, we've seen, of course, unexpected patterns of correlation in the movement of asset prices and in credit losses across sectors and industries.

Now, these experiences have led to a number of changes in risk management and supervision. These responses have reduced the overall vulnerability of the system to the types of shocks we've seen. And because we've experienced such a variety of different types of shocks, overall risk in the system may be lower. But this recent history also suggests we need to maintain a degree of humility and caution about our capacity to anticipate the nature and dynamics of future stresses to the financial system.

How strong and resilient is the U.S. financial system today? Our sense is that the system is quite strong and quite resilient relative to the recent past. And let me just list some of the factors that form that judgment.

The major financial institutions at the core of the system are profitable and well capitalized. Capital is very important because capital, along with earnings, provides the first line of defense against losses. Counterparties and customers are less likely to lose confidence and pull back from a well-capitalized institution in the wake of a large loss or otherwise negative shock.

Consolidation has resulted in larger, more diverse financial institutions at the core of the U.S. system with a larger, more diversified and somewhat more stable earnings base. Earnings of this magnitude provide a substantial cushion against loss and improve our capacity to withstand the consequences of an adverse event. And the wider scope of activities and greater domestic and international diversification of these firms provides a more stable earnings base.

Advances in risk management have enabled firms to hedge risks more effectively and to disperse risks more efficiently across firms in the financial system. In combination with better risk modeling, securitization and credit derivatives have facilitated the dispersion of credit risk across firms and across sectors of the system. These changes have led not just to significant risk transfers within the system, but a net transfer of credit risk and other risks from commercial banks to other financial intermediaries. And as a result, we believe that we've seen a more efficient allocation of risks both within the financial system as a whole, and to parts of the system that are less leveraged than those financial, traditional financial intermediaries again at the core of the system.

These risk management advances have been accompanied by the growth, by very rapid growth in derivatives markets that have lowered the costs of hedging. The growth of these markets reflect a very substantial increase in hedging capacity. And this much wider pipeline of capacity seems likely to facilitate the ease with which markets adjusts to conditions of stress.

Growth in these markets has been accompanied by, in these derivatives markets, by quite important improvements in market practice. Since '98, financial firms have made significant progress in the sophistication with which they assess and manage counterparty credit exposure. Rather than using the broad "rules of thumb" that were once the industry norm, derivatives dealers now commonly assess counterparty exposures on a portfolio basis using approaches that better capture potential future exposure. And these models make possible – though of course they cannot guarantee – an appropriately conservative assessment of the potential reduction in future exposure that's provided by netting agreements and collateral arrangements. Dealers have made significant strides in developing and employing more exacting ways to stress test their exposures, and together, these approaches have resulted in more realistic measures of counterparty exposures and to better management of those risks.

Collateral, the use of collateral, is more prevalent than in the past, and there's been significant improvements in the legal certainty surrounding these collateral arrangements. The development of new clearing arrangements has strengthened the resiliency of the settlement payments and settlement systems that provide the backbone for our system. And existing systems have put in place stronger safeguards not only against the risk of failure of a major participant but also against the potential impact of external events, such as those experienced on September 11.

Now overall, these changes suggest that, at a fundamental level, we've made significant progress in strengthening the resiliency of the U.S. financial system. Higher levels of overall capital, greater diversification of credit exposure, increased use of collateral, and the stronger payment and settlement system make our system stronger today than it has been. But, of course, with these favorable developments have come a range of challenges, and I want to talk about a few of these and their implications. But this is not meant to be, and it could not be, a comprehensive list of those challenges.

The first is the challenge of complexity. With financial growth and innovation, we have seen a dramatic increase in the complexity of the risk management challenge. The frontier of innovation inevitably advances somewhat ahead of the pace of improvements in the risk management and supervisory infrastructure. The models and approaches we use to inform credit judgments, to measure exposure, and to price risk in these newest areas at the frontier of innovation are by definition less well grounded in experience. And the process of assigning fair or market value is much more subjective and much less amenable to objective verification. Consensus on the appropriate accounting treatment is less well established.

As the complexity of the instruments has grown, so have the demands on firms to understand how exposures evolve, might evolve in times of market stress. Just to take one example, basis risk – the risk that hedged positions do not fully offset one another – is obviously an important concern for many firms, particularly those that deal in complex products such as options. Assessing and managing these complex risks requires risk management tools with a commensurate level of sophistication. And the further development of techniques for stress testing and scenario analysis and of methods for translating these stress test results into concrete risk management outcomes are important continuing challenges.

This risk management challenge is complicated by the nature of the institutions at the core of our system. Large, diversified financial institutions comprise many separate, highly specialized units, each of which often have their own approaches for tracking and managing exposure. Integrating these businesses to develop a firm-wide risk perspective is an important continuing challenge. The difficulty in managing conflicts in dealing with customers is necessarily greater, the greater the scale of the institution.

More generally, it's increasingly challenging for many large, diverse financial institutions to get an accurate picture of their aggregate exposure to individual creditors when their business contacts come through so many different sources within the firm. This difficulty is compounded when different types of exposures that are functionally equivalent are managed in different ways in different parts of the firm.

The increased scale and scope of operations of these institutions and the rapid growth in complex transactions place an extraordinary burden on the internal control, compliance, and risk management infrastructure. This is the "arms race" in finance. It is the challenge of ensuring that the strength of the infrastructure within institutions stays abreast of the pace of change in the complexity of risks and the tools we use to manage them, and this is a process that we as supervisors must actively reinforce.

A second issue relates to the degree of concentration in some core financial intermediation functions. The two largest government-sponsored agencies, enterprises in the mortgage market now hold 36 percent of agency mortgage-backed securities compared with less than 10 percent at the end of '93. The exposure of banks to these GSE's is as a consequence very large. Two institutions now account for, now handle essentially all of the clearing function for government securities and agencies, as well as for tri-party repo activity. And a relatively small number of institutions now account for a large share of activity in the over-the-counter derivatives business generally and in certain parts of that business.

These developments have very different sources. Some are the result of public policy choices. Some are the natural consequence of the economies of scale inherent in these businesses. Overall, we believe we have a very competitive financial system, with a larger diversity of institutions than we've had in the past, and therefore a stronger overall system of financial intermediation. However, the increase in the size of some institutions relative to some parts of our system necessarily magnifies the potential consequences of a mistake or an infrastructure failure. And these institutions are sufficiently large that they have less room to maneuver in adjusting positions in response to changing risks without adversely affecting markets as a whole. Increased concentration in some markets should reinforce the incentive the largest institutions and their counterparties have to manage risk with a greater degree of caution. But we have a role here too as supervisors in reinforcing those incentives.

A third challenge is the increased opportunity that exists today for risk and leverage to migrate to, and build up in, parts of the financial system that are not subject to direct supervision and regulation. According to some estimates, assets under management in the hedge fund community as a whole have doubled since '98, as have the number of firms. We have no reliable overall measure of the degree of leverage in these institutions, but I think it's important to note that the intermediaries that serve as prime brokers to these hedge funds believe that overall leverage is lower, is lower than in early 1998. Given the growth in this market, credit exposure of banks and securities firms to the overall hedge fund sector may be higher today than in 1998, but is likely spread more widely. And there may well be more diversity in the types of strategies hedge funds follow today, but there is also considerable clustering, which raises the prospect of larger moves in some markets if conditions lead to a general withdrawal from these “crowded” trades.

Overall, we believe that hedge funds can play a beneficial role in the U.S. financial system. They contribute to one of the defining strengths of our financial markets which is the ease with which we match capital to ideas and innovation. They represent one aspect of a broader, quite favorable, trend toward a greater diversity of participants in the U.S. financial system. And in this sense, they contribute to a broader spreading of risk. But they also present risks to the system.

The extent of the risk they present depends significantly on the prudence of the institutions that enable them to take on leverage. And the improvement in market practice in managing counterparty credit risk since 1998 is encouraging in this respect, but of course it’s important that firms continue to strengthen those disciplines. Intermediaries that provide credit to these institutions need to ensure that the terms and conditions on which they provide credit – including the contingent credit that is an increasing part of prime brokerage arrangements – appropriately reflects the risks involved.

What are the implications of these challenges to what is overall quite favorable picture of the strength in the U.S. financial system? One of the more persistent features of financial history, of course, is that discipline tends to ebb and flow a bit with changes in financial and economic conditions. Even though we've seen a broad-based, secular improvement in risk management practice over the past decade, competitive pressure and the search for return in a low interest rate environment can lead to a relaxation of internal safeguards even as potential risk in the balance sheet increases.

There are a number of factors, however, that suggest that these forces have not led to the buildup of major imbalances that would be a source of strain, of major strain, as these incentives diminish in a changing financial environment. Net borrowing by the non-financial corporate sector has been quite moderate in this cycle. Credit to the household sector has risen quite considerably, but debt service burdens in that area look quite manageable still. Net credit growth to emerging markets has been moderate relative to past periods, and the recent pace of growth in commercial bank assets has also been quite moderate.

As the financial markets have built in expectations of a gradual return to more normal monetary and financial conditions, we have seen some adjustment in a range of credit spreads. And as surveys suggest, have been reporting for some time that dealers and the financial intermediaries generally have been reducing their exposure to rising interest rates.

These are healthy adjustments for the system. The fact that their impact has been relatively contained so far may suggest that borrowers and lenders were less overextended relative to past periods, despite the sustained period of accommodative financial conditions. That this process of adjustment has been relatively modest may also reflect the fact that it has occurred in an environment of growing confidence in the sustainability of the expansion and a private consensus forecast for relatively moderate inflation going forward. Even so, risk managers need to continue to be attentive to the implications of further evolution in monetary and financial conditions.

This overall picture suggests that the supervisory community should continue to focus on ensuring that capital levels provide a sufficiently strong cushion against risk, encouraging firms to strengthen the internal management and control infrastructure, improving the quality and integrity of public disclosure, and continuing to work towards a more integrated framework for supervision across the functional lines of financial activities in our markets, and globally as well.

For us at the Federal Reserve, this means that we will devote even greater attention to the institutions that now constitute the center of our financial system and to core clearance and settlement backbone. It means we will make greater investments in looking at risks in the financial system as a whole, and it means that we will continue to intensify our cooperation with other supervisory and regulatory authorities, both within our markets and globally.

The U.S. financial system is of course only as strong as our economy as a whole. Overall, I think it’s fair to say that the fundamentals of the U.S. economy look very strong. But the size of our fiscal deficit, and the risks posed by our large external imbalance, place a greater burden than would otherwise be the case on the credibility of U.S. monetary policy. In this context, it is particularly important that we preserve the high degree of confidence that now seems to exist that U.S. monetary policy will respond appropriately to the evolving balance of risks in the overall economic outlook, and in particular that we will maintain price stability. This is critically important to sustaining the expansion, and to sustaining confidence in U.S. financial markets over time. Thank you very much. (Applause)

Chairman Barbara Hackman Franklin: Thanks very much Tim. You've covered a lot of ground in a very succinct fashion and we really appreciated hearing everything you had to say. Now we'll turn to John. John Thain was appointed President and CEO of the New York Exchange in January. His appointment capped an intensive search led by interim head John Reed for the right person to lead the exchange into a new era. The NYSE is 211 years old, is the most important exchange in the world, and a bulwark of the U.S. brand of entrepreneurial capitalism.

John has been described as someone who has the ability to synthesize complex information and then bring about consensus around a plan of action, two important skills. He also brings to his new role a great depth of knowledge about financial markets and technology. He distinguished himself early in his 24 years at Goldman Sachs. Most recently he was President and Chief Operating Officer and has been a Director since 1998. His prior posts at Goldman included Chief Financial Officer and Head of Operations Technology and Finance as well as co-Chief Executive Officer for European Operations.

In his first 100 days at the exchange, he has promoted changes to restore confidence among investors and to make the NYSE more responsive to all of its constituents. One of the challenges ahead is finding the most effective way for the exchange to offer investors top speed in executing trades as well as best prices. And in today's *Wall Street Journal* he has a very thoughtful piece about the costs and benefits of Sarbanes-Oxley. We're eager to hear what he has to say. Please welcome John Thain, President and CEO of the New York Stock Exchange. (Applause)

John A. Thain
President and Chief Executive Officer
New York Stock Exchange

Well, thank you Barbara. It is an honor to have this opportunity to address the Economic Club of New York. Your organization has long been valued for its role in providing a nonpartisan forum to discuss great issues of the day. The Economic Club of New York also has a reputation for attracting interesting and important people. And this afternoon I am very pleased to be speaking today along with my friend Tim Geithner. Tim was a terrific choice to head the New York Fed and he's been very helpful to me in thinking through important issues during my first few months at the exchange.

It's customary to begin a talk like this by pointing to pressing problems that seem to be unique at the time. Looking back over the past century which witnessed two world wars, conflicts in Korea and Vietnam, rampant inflation, the Cold War, the energy crisis, it's difficult to find moments that were problem-free. Nevertheless, the first few years of this new century have particularly tested the mettle of the American people as well as the resilience of our institution.

Over the course of a relatively few months, the United States was attacked for the first time since Pearl Harbor and responded by sending troops into combat and declaring war on terrorism. We entered an economic downturn that became global, and we endured a series of scandals that severely undermined confidence in U.S. capital markets and corporations. Each of these challenges shook the nation to its core and collectively they have severely tested America. And the manner in which our country responded is impressive. As we recall the meaning of Memorial Day this weekend, past and present, we are thankful for the men and women who fight for our freedom around the world. Now more than ever, our men and women in uniform deserve our support.

Here at home the U.S. economy is recovering. And what was first referred to as a jobless recovery now is regarded as a strong expansion with solid job growth leading the industrial world. And at the same time, business leaders are taking meaningful steps to increase their company's transparency and disclosure and to improve corporate governance.

I make these points to remind us that sometimes we need to bring some perspective to our national conversation. Sometimes it's a good thing to acknowledge that progress has been made and also the good faith efforts most people, including those in business, are making to address problems and to meet commitments. And sometimes it's also important to recognize when we've gone far enough.

In considering U.S. regulatory policy, I believe we have reached such a moment today. For just as patients can be overmedicated to the detriment of their health, we need to use care in setting the proper dosage of reporting and governance requirements for business and for markets. As we examine these issues, it appears that we're challenged by competing priorities, those of regulation and accountability versus growth and competitiveness. Hence, a logical question arises. Is there a way to resolve these competing priorities? Can we find common ground?

I believe that we can. I believe there's a unifying theme and that is the central importance of investor confidence – the confidence of American investors as well as investors around the world. Improving investor confidence goes hand in hand with higher standards of corporate governance as it does with better economic performance. The test, it would seem, is to ensure that U.S. standards of corporate governance do not become the enemy of U.S. economic performance. These interests must not be competing but complimentary and mutually beneficial.

So today I will focus on strengthening investor confidence by setting our sights on two clear and complementary goals. First, meeting high ethical standards and corporate accountability. And second, making certain that the regulatory burden does not harm U.S. competitiveness and the ability of our capital markets to fulfill their central role.

U.S. capital markets serve an essential national role by allocating scarce capital to supply corporate, venture, and risk-taking needs. U.S. capital markets are the broadest, deepest, and most liquid in the world. They're the wellspring of our prosperity. They provide visionary people with the means to transform ideas and innovations into jobs, opportunities, and enterprises. They have enabled the United States to become the global champion for economic growth and a better life. And while the U.S. is the powerful engine of global capitalism, there's no birthright that dictates that we will remain so.

In the 21st century economy, great forces of competition and technology are accelerating change and the mobility of capital. The willingness of investors to commit their capital will be influenced by how well capital is treated, by the degree to which markets and economies encourage and reward investment, risk-taking, profits, and growth. In this regard, U.S. tax policy has moved boldly to unleash the spirit and dynamism of entrepreneurship which is America at its best, and thank you Glenn.

At the same time, Sarbanes-Oxley and other disclosure requirements, including those of the New York Stock Exchange, ensure that companies have solid governance structures, that corporate financial statements are accurate, and that all relevant facts about companies are disclosed. As a consequence, individuals can better understand the risks of investing in publicly-traded U.S. companies. They can better manage their portfolios and make better informed decisions.

These are important reforms. However, they come at a cost – both in the expense companies incur and in senior management's time and effort to comply with the rules. Clearly, the ethical breakdowns, and in some cases criminal behavior in the most recent corporate scandals broke fundamental bonds of trust with investors. For thousands of people it resulted in the loss of a livelihood and of life's savings. These scandals clearly illuminated the need for a new commitment to higher standards of corporate governance and accounting and regulatory oversight.

Chairman Donaldson described Sarbanes-Oxley as the most important securities legislation since the original federal securities laws of the 1930s. I agree with that. Sarbanes-Oxley is groundbreaking legislation. The new governance and accountability standards are far-reaching. The strength of the legislation, reinforced by the efforts of Bill McDonough at the Public Company Accounting Oversight Board, is helping to restore investor confidence in U.S. companies.

Having said that, we also need a sense of balance, a sense of perspective. It would stand at the vital center of global growth and prosperity. At the end of 2003, Americans held $12 trillion of U.S. and non-U.S. equities which represented 38% of the market cap of the world's major exchanges. In addition, foreign and domestic companies raised $122 billion in new capital on the three major exchanges during 2003. That's a third of the capital raised publicly in the world stock markets. The stakes are great. As other nations forge ahead to develop markets and lure investment, the U.S. cannot afford to stifle investment and innovation, to forfeit competition, and to fail to answer 21st century challenges.

So, let me address these issues from my perspective as CEO of the New York Stock Exchange, in that capacity, as a voice for 85 million investors and the leaders of 2,700 listed companies who I believe want the U.S. to compete to its fullest potential. Since becoming CEO of the exchange four and a half months ago, I've worked to restore confidence in the integrity of the exchange. I've also spent a great deal of time listening to our customers.

In conversations with leaders of New York Stock Exchange-listed companies as well as with executives from abroad hoping to do business here, I continue to hear the same refrain. They're saying the pendulum has swung too far. The costs of compliance are too high. The risks of litigation are too great. And thus, we'll avoid the risks. We'll defer our decisions. We'll delay our investments.

Some of these comments are the inevitable reflection of adjusting to the new era of compliance and governance. As companies adjust to that new reality, these complaints should diminish. But in the meantime, companies around the world are voting with their feet. One sign of that negative posture can be seen in the decline of new listings of foreign companies in the U.S. financial markets. Between 1996 and 2001, the New York Stock Exchange listed an average of 50 non-U.S. companies a year. During the past two years, that number dropped to 25, with the decline particularly sharp among European companies dropping from 19 to 6. And so far this year there has only been one new listing of a European company.

Listings are an important barometer of foreign interest in the U.S. economy. Listings offer a multitude of possibilities. A foreign company that lists in the U.S. can access the largest pool of capital in the world and diversify its shareholder base. It can position itself to engage in mergers and acquisitions. It can enhance the visibility of its commercial brand. And its adherence to rigorous U.S. corporate governance, accounting, and our stringent listing standards can bolster investor confidence and goodwill. Investor confidence in turn can lead to higher valuations and better equity performance. Obviously, from a national standpoint every listing strengthens possibilities for more U.S.-directed investment, more growth, and more jobs.

Unfortunately, the recent drought in foreign listings indicates a declining willingness or necessity to participate in U.S. markets. I see four fundamental causes. Three are U.S.-centric and one is Euro-centric. First, Sarbanes-Oxley, and especially the new Section 404, internal control requirements. They take time, effort, and resources from all levels of management to implement.

The value proposition for overseas companies seeking to list in the U.S. and to remain listed changes fairly significantly when the cost of meeting our reporting requirements are so high. Companies we have spoken to note the complexity of integrating international operations into these new processes. They note the high expense to build, test, and maintain systems and software to monitor operations consistent with the new rules and guidelines. In some cases, these requirements could increase current accounting costs for European firms listed in the U.S. by up to 100%. As many other countries in the EU have adopted policies similar to Sarbanes-Oxley, our competitive disadvantage should shrink, but for now we expect to see the listings of overseas companies remain lower than they would otherwise be.

Second is the lack of convergence in account standards between the U.S. and Europe which presents a major obstacle. European nations are preparing to meet their 2005 deadline for a new EU reporting system. The FASB and the IASB are endeavoring to reach an accord but so far they have not.

Third, the reputation of the U.S. as a growing target for anti-business litigation and potential liabilities from class action lawsuits has set off alarms here at home and abroad. A 2002 foreign securities litigation study by Price Waterhouse showed the number of foreign companies involved in class actions increased by 47% during 2002. As class action lawsuits increase, the cost of premiums for directors and officers, D & O coverage, rose by 33% the same year.

And the fourth is an external factor. Europe has succeeded in gaining universal acceptance for the Euro. A European equity culture is gaining in sophistication and strength. As a result, the development of a large, liquid European capital market is becoming a reality which reduces the need for foreign firms to rely on the U.S. market to raise capital. Nor can we ignore that Japan's markets are recovering and, of course, China and India are booming.

In sum, global capital markets in the 21st century are developing rapidly. They are more robust, more competitive, and more liquid, and they are challenging U.S. leadership and preeminence. That describes the situation we face in bringing new listings of foreign companies to our exchange and to American investors.

Not surprisingly, these same issues are affecting U.S. companies as well. In the U.S. today there is consternation over the maze of overlapping governance in reporting requirements above and beyond requirements already mandated by Sarbanes-Oxley. Credit rating agencies, independent corporate governance groups, and others are now asking companies to submit extensive questionnaires and data which overlap and often go beyond what is required by Sarbanes-Oxley or by the New York Stock Exchange. CEOs are expressing deep concern over steeply rising costs, complexity, and delays.

Since the inception of Sarbanes-Oxley, fees paid to outside auditors have increased by double digits year over year. A recent survey of 115 firms by Foley and Lardner showed that on average the cost of complying with audit and reporting requirements for public companies with annual revenues under $1 billion – smaller cap companies – has increased by 130%. The Foley and Lardner survey also revealed that audit fees have increased 20% for small cap companies and 24% for the S&P 500 in each of the past two years.

The SEC is expected to approve new peek-a-boo rules concerning Section 404. The rules will require outside auditors to do a full audit of a company's internal controls to assure that they are sufficient. This requirement could double audit costs. Compliance efforts have required an average of 12,000 hours of internal work and 5,000 hours of external work which was double the original estimates. And there's a particular global-listed company who was talking to me before this started today who said to me that they had spent 250,000 hours on their Section 404 compliance.

Now, according to another survey – this one is by Tillinghast-Towers Perrin – at current levels U.S. tort costs are equivalent to a 5% tax on wages. The cumulative effect of these changes is sticker shock and a mood of frustration and anxiety. The tremors across the corporate landscape affect all companies, large and small. Hank Greenberg, the chairman of AIG, spoke for many of his colleagues recently when he said some of us have two jobs – the regulatory burden during the day and running the company at night.

Public companies are contemplating a step that a few years ago would have seemed unthinkable. Foley and Lardner reported that one-fifth of U.S. public companies are considering going private because of the rising costs of governance regulations. We do not want America's most promising and successful companies to start pulling back from our capital markets.

While I do not pretend to have all the answers, let me share some common sense principles as well as some specific proposals to strengthen investor confidence. Starting with general principles, I think we need to start by reaffirming the central role of enterprising capital markets – quite simply free people competing in free markets are the wellspring of prosperity and progress in free societies. Winston Churchill was fond of saying that some regard free enterprise as a predatory tiger to be shot. Others looked upon it as a cow to be milked. Only a few see it for what it really is, the strong horse that pulls the cart. We need to let America's strong horse pull our economy forward or else we won't get to where we want to go.

In that regard, I believe we need to remind ourselves that the leaders of corporate America are – in the great majority – honest men and women. They awake each morning with the intent of doing it right and doing right by their customers and stakeholders. I believe that in matters of government and regulation we should be guided as we are in medicine by an equivalent of the Hippocratic Oath – do no harm. To do no harm, we need to look closely at the risks to investors and to our financial system and mitigate the greatest of the risks. We need to strike the proper balance between the costs of increased time and resources devoted to compliance and the incremental benefits that they will produce in terms of transparency and governance.

It is a positive sign that in the past 12 months, despite uncertainty at home and abroad, net new cash flow into equity funds has been positive – $85 billion in net new inflows in the first quarter of this year. Investors have not lost sight of the opportunities presented by our capital markets and Wall Street has learned not to lose sight of the investor. Still, investors want to see real returns on their investment dollars. They want to see CEOs devoting their time to managing and growing their business. They want to see companies spending reasonable amounts of resources on disclosure and compliance.

So let me conclude with some specific suggestions on the implementation of some of these rules and how they can be streamlined so that the principles of Sarbanes-Oxley remain intact but at a price that makes sense to the economy.

First, for the sake of all companies running global businesses, let us push for convergence of FASB and IASB standards. We would eliminate the need for companies to keep two sets of books and significantly simplify companies' corporate finance decisions. Second, let us reform our tort system. Third, let us clarify for listed companies and auditing firms alike the Sarbanes-Oxley implementation rules. We, at the New York Stock Exchange, would be willing to bring together a representative group of listed companies to discuss these rules and the cost-benefits of the new requirements. And finally, let us insist upon standards of reasonableness in determining the resources that companies will have to spend to meet the rules.

I have every confidence that we can take these steps and realize what Bill Donaldson said of Sarbanes-Oxley at its one-year anniversary last July. He said, “Indeed, a new period marked by responsibility and realism could provide the foundation for a new era of long-term growth and prosperity.” Let us build that foundation, a foundation of good governance, dynamic entrepreneurship, and competitive markets that strengthen investor confidence, and ensure that the United States remains the investment capital of the world. Thank you. (Applause)

QUESTION AND ANSWER PERIOD

CHAIRMAN BARBARA HACKMAN FRANKLIN: Thank you very much John. For those of us, probably everybody in this room one way or another – myself included – who wrestle with all the new governance requirements almost every day, your remarks, your thoughtful comments are really a breath of fresh air. So we thank you. (Applause) Now our two excellent speakers can be challenged by our two astute questioners. We have on the left side of the dais, Susie Gharib, who is the co-anchor of PBS’ Nightly Business Report, and on the right side of the dais, Glenn Hubbard, who has been Chairman of the President’s Council of Economic Advisors, now a Professor of Economics and Finance at Columbia, and soon to be the Dean of the Columbia Business School. Susie, the first question is yours.

SUSIE GHARIB: Thank you Barbara. My first question goes to Timothy Geithner.

CHAIRMAN BARBARA HACKMAN FRANKLIN: Tim, the questioners can address either one of the speakers or both of them.

TIMOTHY F. GEITHNER: I thought we'd do it, that John would do monetary policy and I'd do the trade-through rule. (Laughter)

SUSIE GHARIB: My first question is about oil prices. Economists have been studying the historical link between high oil prices and recessions, and most of the last recessions have been preceded by a spike in oil prices. The research suggests that it's not oil prices themselves that cause the downturns, but it's the Fed's response to the oil shocks by way of higher interest rates. Today, how much of a factor is the sustained high price of oil, how much of a factor does it play in determining monetary policy?

TIMOTHY F. GEITHNER: Good question. Excellent question, and I think you did a good job, good job summarizing the research, although I'm not sure the consensus is quite as strong as you suggest, on the record. You know we've seen a pretty substantial increase in oil prices and energy costs sustained for a fairly long period of time. And as Chairman Greenspan has pointed out, we've seen a very significant increase in the long-term futures price. Now it is somewhat encouraging that despite those movements, that the consensus of private forecasts for growth in the U.S. economy over the last 18 months have stayed pretty firm – sort of in the, sort of slightly north of 4 range. And the expectations revealed in those forecasts about the outlook for core consumer prices also suggests a pretty moderate increase in underlying inflation over that period of time. And so I think we can take some comfort in that. I guess the other thing you'd say, and I think we can hope is that central bankers everywhere – certainly in the United States – have learned a lot from the mix of different types of oil shocks we've seen and that knowledge should contribute to a wiser response going forward.

GLENN HUBBARD: As with OPEC, Susie and I colluded a little bit on the order; my question is for John actually. You had a very interesting set of remarks, a great ___, especially the emphasis on entrepreneurship and the link to capital markets. The Foley Lardner study, of course, was a page one story in *The Financial Times* last week, particularly of concern because companies with under a billion dollars in revenue were facing more than doubling of costs. My question is, could you please make clear your concerns with Sarbanes-Oxley in this regard, and as a legislative matter, generally when things pass 99 - 0 in the U.S. Senate, they have some issues or problems with them – my question is do you see the need to open Sarbanes-Oxley comprehensively as a legislative matter or just to bring together business people to clarify the details?

JOHN A. THAIN: Thank you. That's a great question. But I have to start with Tim's opening line about me commenting on monetary policy and him talking about the trade-through rule. You know, I've always been very jealous of Tim because between he and Alan Greenspan, they get to move around interest rates so everyone listens intently to anything that they say. The only thing I can control in my marketplace is who rings the opening bell. (Laughter) In terms of Sarbanes-Oxley, no, I don't think that we have to reopen it legislatively. It actually has quite a bit of flexibility in it for the SEC to interpret it. And actually the SEC did a very good job initially interpreting it where certain of its provisions actually conflicted with other governmental entity law so it had particular problems with German companies and with Japanese companies. And so the SEC has plenty of ability to interpret it, and actually Bill McDonough and I were talking about this earlier. Between the SEC and between he and peek-a-boo, I think actually there can be a lot done particularly for smaller companies to relieve some of the burdens.

SUSIE GHARIB: Don't go away John. I have a question for you. I enjoyed reading your Op-Ed piece in *The Wall Street Journal* this morning, but there was another Op-Ed piece in the journal this week that also got a lot of attention. And I think you know the one I'm talking about. Dick Grasso gave his response to the Eliot Spitzer lawsuit and he said that his lavish pay package had been approved by six different compensation committees and boards of directors and that he doesn't think he did anything wrong in accepting the payments. What is your response to Dick Grasso?

JOHN A. THAIN: You know I'm glad to see all members of the media have a one-track mind. (Laughter) I took this job to focus on the future and I have been focusing all of my efforts on moving the stock exchange forward, both from its reputation and from how the marketplace works. I have not focused at all on the past and I'm not going to start now. Sorry. (Applause)

SUSIE GHARIB: Well, let me come at it, if you'll allow me just a followup. Let me come at it in a different way then.

JOHN A. THAIN: I predict it won't be successful. (Laughter)

SUSIE GHARIB: Beyond the Grasso episode, there have been a number of missteps on the part of the New York Stock Exchange when it comes to self-regulation – things like IPO laddering, improper trading by specialist firms, conflict of interest issues with research analysts. And to many investors it appears that self-regulation has failed. Why should investors think that the New York Stock Exchange can regulate itself?

JOHN A. THAIN: Without getting into your list of atrocities, not all of which are really attributable to the New York Stock Exchange, I'll answer your question in general on self-regulation. There have been failures of self-regulatory bodies and the specialist was certainly one from the New York Stock Exchange's point of view. But there's also failures of third party regulators, and actually many of the big corporate scandals, those entities were regulated by third parties. So I don't think you can argue that one model or the other never has failures or that one model or the other always dominates the other. The important thing that we've done at the New York Stock Exchange is we have made very significant changes in our governance structure. So we now have a new board of directors where the board is completely independent, the board are not members of the exchange, they're not CEOs of listed companies. And so the board itself is independent, it's independent of management with the exception of me. As you all know, we have a new chairman of the board, John Reed. We have a new CEO. And we have a new regulatory structure. Now it is still a self-regulatory organization, but the regulatory part of the exchange has been completely separated from the operations of the exchange. We're very lucky to have Rick Ketchum be our chief regulatory officer. He reports up to a sub-committee of the board of directors. That sub-committee is chaired by Marsh Carter, and that sub-committee also only consists of independent directors. And I, in terms of the operations of the exchange, have nothing to do with the regulatory part of the exchange. So that separation of duties, I think, is very important. Now, it is still up to us to prove that a self-regulatory body works. And I think that's a challenge for us going forward. I think the complexity of our marketplace lends itself more to a self-regulatory model but we have to prove that it works, and that's the challenge for us going forward. Thank you.

GLENN HUBBARD: Okay, my question is for Tim. You noted in your remarks, I think quite correctly, that getting monetary policy right is going to be very important in sustaining the expansion and in guiding good risk management. And financial market participants understand, or at least one hopes that they do, that the Federal Reserve will at some point be withdrawing the accommodative stance of U.S. monetary policy as the recovery continues. Nevertheless, it's a communications challenge as you're guiding risk management. My question of you is this, as you guide market participants, what level of inflationary expectations do you consider too high?

And toward that end, do you believe the Fed should enact or publicly discuss an inflation target to clarify that interest?

TIMOTHY F. GEITHNER: Good question. I'm a little new to the theological debate about inflation targeting. I've listened to the arguments on both sides and looked at them. I think it's going to be an interesting debate for us and other countries going forward. I think you need to ask the question whether you need an inflation target in your regime in order to deliver better monetary policy decisions in the United States than we've had over the past two decades. And you have to ask the question whether you need inflation targeting, again with an explicit inflation target, to provide a substantially greater degree of clarity about the framework that's going to guide monetary policy decisions going forward. I don't think it's clear that you need that framework in order to deliver those two results. There's an interesting set of arguments on both sides of that. I think our job is to be credible in our commitment that we're going to maintain price stability, and our job is to give people as much clarity as we can about the basic framework that informs our monetary policy judgments over time. And I guess my sense is, although I'm new at that table, is that this Fed and the FOMC has been reasonably successful at doing that.

GLENN HUBBARD: And to the point of what level of inflationary expectations would you consider too high?

TIMOTHY F. GEITHNER: Any level that was too high would be too high. (Laughter)

CHAIRMAN BARBARA HACKMAN FRANKLIN: Well, I think that sums it up. I think that's the last word. But thanks both to Tim and John for excellent comments and I think you've given us a lot of food for thought as we go from here today. So please join me in a round of applause.

(Applause)