Statement of

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before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

February 4, 2010

Introduction

Chairman Dodd, Ranking Minority Member Shelby and members of the Committee, I am thankful for this opportunity to share with you my views on the urgently needed financial reform process in the wake of the financial crisis. As the Committee knows, in my earlier career at the Fed and in my current second career in the private sector, public policy issues relating to the quest for greater financial stability have been a subject of continuing interest to me.

The views I will express today on financial reform are very much driven by what I consider to be in the best interest of long-term financial stability. Having said that, I cannot deny that there are instances in which my thinking about specific issues has been influenced by my tenure as an employee of Goldman Sachs and by what I have seen transpire during that period. To cite one clear example, in a sharp departure with my earlier thinking, I now recognize the value and importance of the so-called “fair value” or mark-to-market accounting.

At the center of the great debate about financial reform is the universal agreement that the “Too Big to Fail” problem must be forcefully resolved in order to provide comfort that future problems with failures of large and complex financial institutions will not be “bailed out” with tax payer money. Achieving that goal will not be easy but it is not impossible.

My formal statement contains four sections as follows:

Section I: The Financial Reform Agenda

Section II: Alternative Financial Structures in Perspective

Section III: The Merits of Alternative Financial Structures

Section IV: The Challenges Associated with Enhanced Resolution Authority

Section I: The Financial Reform Agenda

In looking to the future, almost everyone who has seriously studied the causes of the crisis agrees that certain basic reforms are a must. In summary form, those basic reforms include the following:

1. The creation of a so-called "systemic regulator." Among other things, the mission of the systemic regulator would include oversight of all systemically important institutions and, importantly, looking beyond individual institutions in order to better anticipate potential sources of economic and financial contagion risk including emerging asset price bubbles. Anticipating future sources of contagion is difficult but not impossible.

2. Higher and more rigorous capital and liquidity standards that recognize the compelling reality that managing and supervising capital adequacy and liquidity adequacy must be viewed as a single discipline.

3. Substantial enhancement in risk monitoring and risk management and more systematic prudential oversight of these activities.

4. The increased reliance by institutions and their supervisors on (1) stress tests; (2) so-called “reverse” stress tests; and (3) rigorous scenario analysis of truly extreme contingencies.

5. Efforts to intensify the never ending task of strengthening the infrastructure of the global financial system.

6. The creation of a flexible and effective framework for the timely and orderly wind-down of failing large and complex financial institutions (the Enhanced Resolution Authority discussed in Section IV).

7. Substantially enhanced cross-border cooperation and coordination on a wide range of issues from accounting policy and practice to more uniform prudential standards to better coordinated macro-economic policies.

I believe that these measures – coupled with others that are in the House Bill such as tightening up the administration of Section 13 (3) of the Federal Reserve Act – will, over time, reduce the probability of future financial crises and materially help to limit or contain the damage caused by crises. Having said that, I want to underscore three key points: *First;* the execution challenges associated with this reform agenda are enormous. *Second*; the reforms are a “package deal” such that if we fail to achieve any one of these measures the prospects for success in the others will be compromised. *Third;* if we are successful in implementing the agenda over a reasonable period of time the case for wholesale restructuring of the financial system would hardly be compelling.

Section II: Alternative Financial Structures in Perspective

At the risk of considerable oversimplification, there are three somewhat overlapping suggestions on the table that are calling for a major restructuring of the core of the financial system both domestically and internationally. The more extreme of the three is the so-called "Narrow Bank Model" which, in effect, suggests that "banks" should essentially take deposits and make loans. The second approach would limit the scope of activities in banks and in companies that own banks but would allow non-bank affiliates of bank holding companies to conduct certain other financial activities including the underwriting of debt and equity securities while sharply curtailing or prohibiting banks and bank holding companies from engaging in "proprietary" trading and operating or sponsoring hedge funds and private equity funds.

The third approach is the view that subject to a comprehensive and rigorous family of reforms as outlined in Section I, most large integrated financial institutions would be allowed to maintain much of their current configuration while being subject to much more demanding consolidated supervision.

To many, the frame of reference surrounding the debate on these alternatives seems to be very much a matter of black and white. If we were starting with a clean slate, that might be the case. Unfortunately, we are not starting with a clean slate – far from it. Therefore, allow me to briefly focus on a few observations that – in my judgment – frame the perspective to be considered in shaping the debate on alternative financial structures.

First; I have always believed that banks (whether stand alone or part of a Bank Holding Company) are special. Among other things, that is one of the reasons I agreed to take on the role of non-executive chairman of the Goldman Sachs Bank when Goldman became a Bank Holding Company in the fall of 2008.

Second; under existing law and regulation there are now in place rigorous restrictions as to the activities that may be conducted in a bank that is part of a Bank Holding Company and even more rigorous standards limiting transactions that can occur between the bank, its holding company and its non-bank affiliates. Also, under pre-crisis rules regarding the administration of the discount window, access to the discount window applied only to the bank and such access did not extend, either directly or indirectly, to the Holding Company or the Bank's non-bank affiliates. As the Fed winds down its crisis driven extraordinary interventions, I believe we should return to the pre-crisis rules regarding access to the discount window so long as Section 13 (3) lending remains a possibility in extreme circumstances.

Third; under existing law and regulation, the Federal Reserve, as the consolidated prudential supervisor of all US Bank and Financial Services Holding Companies, already has broad discretionary authority to remove officers and directors, cut or eliminate dividends, shrink the balance sheet, etc. The Bill passed by the House in December would further strengthen this authority and extend it to systemically important financial institutions even if they do not own or control a bank.

While on the subject of consolidated supervision, allow me to say a few words about the experience of Goldman Sachs since the Fed (working with other regulators) became its consolidated supervisor 16 months ago. First, and most importantly, I would describe that relationship as open, highly constructive, and very demanding. The Fed has now completed comprehensive full scale examinations of the Bank and the Group and reported the results of such examinations to both the Boards of the Group and the Bank. In addition, a large number of targeted exams and so-called "discovery reviews" have been completed or are in progress. In the case of major forward-looking supervisory initiatives on the part of the Fed in collaboration with other supervisory bodies – both domestic and international – I personally have actively participated in all such discussions. Finally, and to put a little color on this subject, on more than a few occasions my high-level associates at Goldman Sachs have said to me something along the following lines: "these guys (referring to the supervisors) ask damn good questions."

Fourth; given all that we have been through over the past two years, many observers are raising the perfectly natural question of whether society really needs large and complex financial institutions. Whatever else can be said about such large and complex financial institutions, financial services is one of the few sectors of the economy that make a consistent positive contribution to the US balance of payments.

Balance of payment issues aside, I strongly believe that well managed and supervised large integrated financial institutions play a constructive and necessary role in the financial intermediation process which is central to the public policy goals of economic growth, rising standards of living and job creation.

While the business models of the relatively small number of large and complex financial institutions in the US and abroad differ somewhat from one to another, as a broad generalization most are engaged to varying degrees in (1) traditional commercial banking; (2) securities underwriting; (3) a range of trading activities including at least some elements of “proprietary” trading; (4) financial advisory services; (5) asset management services including the management of so-called “alternative” investments; (6) private banking; and (7) elements of principal investing.

All of these large integrated financial groups are indeed large with balance sheets ranging from the high hundreds of billions to $2.0 trillion or so. Among other things, it is their size that allows these institutions to meet the financing needs of large corporations - to say nothing of the financing needs of sovereign governments. The fact that so many of these large corporations operate on a global scale is one of the reasons why almost all large financial intermediaries also have a global footprint. As an entirely practical matter, it is very difficult to imagine how the vast financing needs of corporations and governments could be met on anything like today's terms and conditions absent the ability and

willingness of these large intermediaries to place at risk very substantial amounts of their own capital in serving these companies and governments. One of the best examples of this phenomenon is the role large intermediaries have played in the recent past in raising badly needed capital for the financial sector itself.

For example, over the past two years banking institutions in the US and abroad have raised more than one-half trillion dollars in fresh private capital and the capital raising meter is still running. While there were some private placements, the overwhelming majority of such capital was raised in the capital markets and the associated underwriting, operational and reputational risks associated with such capital raising, were absorbed by various combinations of the small number of large integrated financial groups. Moreover, many of these transactions took the form of rights offerings which involve extended intervals of time between pricing and final settlement thus elevating underwriting risks. The ability and willingness of these large integrated financial groups to assume these risks depends crucially on large numbers of experienced investment bankers and highly skilled equity market specialists who are able to judge the tone and depth of the markets in helping clients shape the size, structure and pricing for such transactions.

More broadly, to a greater or lesser degree, most of these large integrated financial groups also act as day-to-day market makers across a broad range of financial instruments ranging from Treasury securities to OTC derivatives. The daily volume of such market activities is staggering and can be measured in

hundreds of thousands – if not millions – of transactions. As market makers, these institutions stand ready to purchase or sell financial instruments in response to their institutional (and sometimes governmental) clients and counterparties. As such, market-making transactions – by their very nature – entail substantial capital commitments and risk-taking by the market maker. However, the capital that is provided in the market-making process is the primary source of the liquidity that is essential to the efficiency and price discovery traits of financial markets. Moreover, in today's financial environment, market makers are often approached by clients to enter into transactions that have notional amounts that are measured in hundreds of millions, if not billions, of dollars. Since transactions of these sizes cannot be quickly laid off or hedged, the market makers providing these services to institutional clients must have world-class risk management systems and robust amounts of capital and liquidity. Thus, only large and well capitalized institutions have the resources, the expertise and the very expensive technological and operating systems to manage these market-making activities. Having said that, it is also true that some of these activities are, indeed, high risk in nature. Thus, the case for greater managerial focus, heightened supervisory oversight and still larger capital and liquidity cushions for certain activities are all part of the post-crisis reform agenda.

Fifth; in terms of both competition and regulatory arbitrage there is a critical international component to the outcome of the debate on alternative financial market structure in the US. That is, if the United States adopted a materially different and more restrictive statutory framework for banking and finance than,

for example, Europe, the outcome could easily work to the competitive disadvantage of US institutions. Similarly, such an outcome would, inevitably, introduce new pressures in the area of financial protectionism which, given the existing threats on the trade protection front, is one of the last things our country and the world need. Finally, if there are material international differences in financial structure and the "rules of the road" governing banking and finance, it is inevitable that one way or another, clever people, aided by highly sophisticated technology, will find ways to game the system.

To summarize, even before approaching the very complex issue surrounding the pros and cons of alternative financial structures and effectively resolving the "Too Big to Fail" problem, we must recognize that even modest financial restructurings that would directly affect only a small number of institutions worldwide raise many questions about the laws of unintended consequences especially in the context of the larger agenda for reform discussed in Section I.

Section III: The Merits of Alternative Financial Structures

There is no question that the drive to shrink the size and activities of large and complex financial institutions is understandably driven by the political and public outrage about the use of tax payer money to "bail out" institutions that were deemed to be "Too Big to Fail." Given that reality, it follows that many observers believe that the easiest way to solve the problem is via some combination of shrinking the size of these institutions,

and/or restricting their activities in ways that will curtail risk and mitigate the conflicts of interest.

Having said that, it is also true that while financial excesses were unquestionably one of the causes of the crisis, shortcomings in public policy were important contributing factors. Similarly, not all "banks" that received direct tax payer support were large and complex institutions. Moreover, the largest single source of write-downs and losses in financial institutions – complex or not – occurred in traditional lending activities not trading activities. Regrettably, these lending driven losses and write-downs were magnified by certain classes of securitization especially very complex and highly leveraged instruments. Finally, it is also undeniable that all classes of financial institutions – big banks, small banks, investment banks (including Goldman Sachs) and so-called near banks – to say nothing of businesses small and large – benefited substantially from the large scale extraordinary measures taken by governments and central banks to cushion the economic and financial fallout of the crisis.

The most radical of the restructuring suggestions is the so-called narrow bank which would essentially take deposits and make loans. As I see it, and with the exception of community banks, this approach is a non-starter given the long history of credit problems over the business and credit cycle. In other words restricting diversification of risk and revenues is hardly a recipe for stability.

A less extreme, but still transformational structural change has been suggested by Chairman Volcker and endorsed by President Obama. While the broad intent of the

Volcker approach is quite clear there are a number of open definitional and important technical details that are yet to be clarified. One area of particular importance relates to the definition of proprietary trading and, in particular, the distinction between “prop” trading and market making. As I see it, client-driven market making and the hedging and risk management activities growing out of such market making are natural activities of banks and Bank Holding Companies. As such, these activities are subject to official supervision, including on site inspections, capital and liquidity standards and various forms of risk related stress tests.

The Volcker plan would also prohibit “banks” and Bank and Financial Services Holding Companies from owning or sponsoring hedge funds and private equity funds. I believe that the financial risks associated with such ownership or sponsorship can be effectively managed and limited by means short of outright prohibition although bank owners or sponsors of such funds should not be permitted to inject fresh capital into an existing fund without regulatory approval.

More generally, it should be noted that hedge funds and private equity funds are providing both equity and debt financing to small and medium sized businesses in such vital areas as alternative energy and technology ventures. Given the long term benefits of these activities, I also believe there is something to be said for the proposition that, subject to appropriate safeguards, regulated Bank Holding Company presence in the hedge fund and private equity fund space can help to better promote best industry practice.

I am also mindful of the conflict of interest issue raised by Chairman Volcker. There is nothing new about potential conflicts in banking and finance. However, it cannot be denied that in the world of contemporary finance – with all of its complexities and applied technology – managing potential conflicts has become much more challenging. Reflecting that fact of life, so-called Chinese Walls segregating some business units from others is a necessary, but not sufficient, condition for managing potential conflicts. That is why at Goldman Sachs (and other large integrated intermediaries) conflict management policies and procedures are constantly evolving and improving.

Goldman Sachs has established numerous committees and processes to help mitigate potential conflicts. We have a high level Firmwide Business Practices Committee which focuses on operational and reputational risk, including conflict management. We have a dedicated and independent high level worldwide Conflict Management team. We have a Firmwide Risk Committee which focuses on financial risk. The Firm's independent Legal and Compliance divisions, both of which have centralized teams of experts and high level officials who are embedded, but still independent, within all of the revenue producing business units, contribute to conflicts management. All of these committees and business areas are headed by senior officers who sit on the Management Committee. Side by side we have a Suitability Committee and a New Products Committee. In addition, our Capital Committee and Commitments Committee as well as all Division Heads share in the responsibility of helping to manage conflicts and reputational risk.

Section IV: The Challenges Associated with Enhanced Resolution Authority

There is little doubt that a well designed and well executed framework of Enhanced Resolution Authority can address the Too Big to Fail problem and the related Moral Hazard problem. However, it is also true that a poorly designed and poorly executed approach to Enhanced Resolution Authority could produce renewed uncertainty and instability. Indeed, under the very best of circumstances, the timely and orderly wind-down of any systemically important financial institution – especially one with an international footprint – is an extraordinarily complex task. That is why, at least to the best of my recollection, we have never experienced such an orderly wind-down anywhere in the world. In other words, even if we successfully implement all of the reforms outlined in Section I of this statement, that success by itself, will not ensure that Enhanced Resolution Authority can achieve its desired effects. Thus, great care must be used in the design of the approach to law and regulation for a system of Enhanced Resolution Authority.

I, of course, have no monopoly on thoughts on how to best approach this task.
On the other hand, as someone who has devoted much of my career to improving what I like to call the plumbing of the financial system I do have some suggestions as to (1) certain principles that I believe should guide the effort and (2) certain prerequisites that should be in place to guide the execution of a timely and orderly wind-down or merger of a failing systemically important financial institution.

Guiding Principles

First; the authorizing legislation and regulations must not be so rigid as to tie the hands of the government bodies that will administer those laws and regulations because it is literally impossible to anticipate the future circumstances in which the authorities will be required to act.

Second; in my judgment, the authority and responsibility to carry out Enhanced Resolution Authority in a given situation should be vested in governmental bodies that have sufficient experience with the type of institution being resolved.

Third; Enhanced Resolution Authority should be administered using the ongoing approach which probably means the troubled institution would be placed into temporary conservatorship or a similar vehicle allowing that institution to continue to perform and meet its contractual obligations for a limited period of time.

As a pre-condition for conservatorship, one or more of the Executive Officers and the Board of the institution would be removed. The ongoing approach has many benefits including (1) preserving the value of assets that might be sold at a later date; (2) minimizing the dangerous and panic prone process of simultaneous close out by all counterparties and the need of such counterparties to then replace their side of many of the closed-out positions; and (3) reducing, but by no means eliminating, the very difficult and destabilizing cross-border events that could otherwise occur as witnessed in the Lehman episode. However, the ongoing approach is not without its problems, one of which is the sensitive

question of how well an institution in conservatorship for a limited period of time can fund itself.

Fourth: to the maximum extent possible, the rights of creditors and the sanctity of existing contractual rights and obligations need to be respected. Indeed, if the exercise of Enhanced Resolution Authority is seen to arbitrarily violate creditor rights or override existing contractual agreements between the troubled institution and its clients, its creditors, and its counterparties, the goal of orderly wind-down could easily be compromised and the resultant precedent could become a destabilizing source of ongoing uncertainty.

Finally; the orderly wind-down of any large institution – particularly such an institution having a global footprint – is a highly complex endeavor that will take patience, skill and effective communication and collaboration with creditors, counterparties and other interested parties. Shrinking a balance sheet or selling distinct businesses or classes of assets or liabilities may prove relatively simple but the winding down of trading positions, hedges, positions in financial "utilities" such as payments, clearance and settlement systems is quite another matter.

Pre-requisites for Success:

First; as a part of the reform of supervisory policy and practice, supervisory authorities responsible for systemically important institutions must work to insure that "prompt corrective action" becomes a reality not merely a slogan.

Second; the official community must work with individual systemically important institutions to ensure that all such institutions have – or are developing – the systems and procedures to provide the following information in a timely fashion.

- Comprehensive data on all exposures to all major counterparties and estimates of all such exposures of 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 securities positions)

- Accurate and comprehensive information on a firm's liquidity and the 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

- Comprehensive information on the firm's positions with exchanges, clearing houses, custodians and other institutions that make up the financial system's infrastructure

I am under no illusion that these guiding principles and prerequisites are anything close to the last word in seeking assurances that Enhanced Resolution Authority can deliver on the promise of a stability driven solution to the “Too Big to Fail” problem. On the other hand, I very much hope these suggestions will help to stimulate discussion and debate on this critically important subject.

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