

Blankfein's Handelsblatt remarks

09/09

Good afternoon. Thank you for the opportunity to be with you today. I thought I would take a few minutes to attempt to frame some of the core policy and regulatory issues that all of us are trying to come to consensus around in the next few months.

In the wake of the financial crisis, there has been no shortage of approaches to regulatory reform, both here in Germany and globally. In a relatively brief period, we have witnessed a number of proposed changes to the rules and regulations that govern our industry and markets more broadly.

Driving these are several common themes, but I want to touch on three that seem particularly prevalent: a backlash against complexity in financial products and markets, the need for macro-prudential regulation to address systemic risk and re-working compensation practices to dis-incentivize excessive risk taking.

First, the industry let the growth and complexity in new instruments outstrip their economic and social utility as well as the operational capacity to manage them. As a result, operational risk increased dramatically and this had a direct effect on the overall stability of the financial system.

That is one reason why Goldman Sachs supports the broad move to central clearing houses and exchange trading of standardized derivatives. Clearly, there is general agreement on the necessity of central clearing for derivatives. A central clearing house with strong operational and financial integrity will reduce bi-lateral credit risk, increase liquidity and enhance the level of transparency through enforced margin requirements and verified and recorded trades. This will do more to enhance price discovery and reduce systemic risk than perhaps any specific rule or regulation.

The debate gets harder when defining what should be traded on or off an exchange. We believe that all liquid OTC derivatives should be centrally cleared. And, where trading volumes are high enough and price discovery mechanisms can be established, regulators should strongly encourage exchange trading. In less liquid markets, prompt reporting of aggregated pricing and clearing is necessary to improve transparency.

More generally, it is incumbent upon financial institutions to recognize that we have a responsibility to the financial system which demands that we should not favor non-standard products when a client's objective and the market's interests can be met through a standardized product traded on an exchange.

But, we should also recognize that underlying the development of the derivatives markets was client demand for individually-tailored solutions. During the financial crisis, credit-default swaps, many of them customized, actually worked as they were intended to. They increased the ability of market participants to diversify their credit exposure in companies -- some that were financially strained or ultimately went bankrupt -- by swapping default risk with others. In that vein, these instruments represent an important economic and social purpose.

If we simply ban customized derivatives to satisfy the perception that everything associated with these markets is bad, we run the risk of limiting risk capital, ultimately reducing capital expenditures, business investment and, ultimately, economic growth.

I believe the public policy goal is to retain the economically valuable attributes of these markets, while mitigating the systemic risk they pose through the right infrastructure and incentives to manage it.

To me, the right incentives should be at the heart of reform and this is particularly true with respect to how non-standard derivatives are managed. Customized derivatives should entail more rigorous capital requirements, for instance. The pros and cons of buying and selling derivatives on or off an exchange should be immediate and clear to all market participants.

The second theme that is attracting a lot of focus is macro-prudential oversight. I know many are focused on who in Europe and the US may ultimately be tasked as the systemic regulator. But the more important question is how will they systemically manage risk?

As I look back prior to and at the beginning of the crisis, I never knew if we were right or the market was wrong with respect to what assets, if any, would deteriorate, and, if so, when. But I believe we had enough timely information that provoked us to be a bit paranoid about the market signs.

I think this informs a larger issue for systemic regulation: How can we expect those responsible for systemic risk to effectively discharge their responsibilities if they have a limited ability to spot changes in asset values and the associated risks of those developments?

I see four areas that, I believe, are fundamental to effective systemic regulation.

First, all of the exposures of a financial institution should be reflected through the P&L. Consider Structured Investment Vehicles or SIVs and other off-balance sheet vehicles that represented significant sources of funding for financial institutions around the world. Unfortunately, risk models failed to capture the risk inherent in these activities. Post Enron, that is quite amazing. If contingent liabilities and

stand-by credit commitments don't flow through the P&L, how can risk managers and regulators see the risks that a bank is exposed to?

Second, in addition to requiring that all risk flow through the P&L, all assets across a systemically important financial institution should be valued correctly. I've heard some argue that fair value accounting is one of the major reasons for exacerbating the credit crisis. I see it differently. If more large institutions had to recognize their exposures promptly and value them correctly, they would have been much more likely to reduce their exposures. Instead, positions were not visible, so they were often ignored -- as were the risks -- until the losses grew to a point that solvency became an issue.

At Goldman Sachs, we mark-to-market every day, not because we are required to, but because we wouldn't know how to assess or manage risk if market prices were not reflected on our books. This approach provides an essential early warning system that is critical for risk managers -- and, I would think, regulators.

If we want to reduce the market and public policy challenges associated with financial institutions that are supposedly "too big to fail," I am hard pressed to think of anything more powerful and necessary than the discipline imposed by fair value accounting.

This type of visibility would be particularly important for a resolution authority that allows regulators to intervene early instead of focusing solely on the unwinding of an institution after it already failed. For instance, fair value accounting facilitates a fast trigger, based on the real-time health of an institution that would force any significant shortfalls in capital to be immediately addressed by reducing risk or raising capital.

Third, regulators need to more regularly and proactively engage market participants. We should get more questions from regulators like, "Where are standards slipping or policies being stretched? Where are pressures building up? And, where are you seeing concentrations in risk?" Our industry lives and breathes on numbers. But that shouldn't overwhelm the value of examples and instances that may very well isolate potential trouble before the black and white of accumulated numbers.

And fourth, coordination among regulatory agencies should improve -- not just between countries but within them. No one can predict the future. Regulators' predictive power isn't better than anyone else's. But it shouldn't be inferior either. One way to guard against that is through the robust sharing of information. There is every reason for different regulators right now to be establishing comprehensive and detailed information on exposures, sources of funding and a host of other key data.

The creation of the Financial Stability Board, formerly the Financial Stability Forum, may be extremely helpful in this regard. Turf battles between regulators shouldn't be allowed to overwhelm a focus on what's in the system's best interest.

Finally, compensation continues to generate controversy and anger. And, in many respects, much of it is understandable and appropriate. There is little justification for the payment of outsized discretionary compensation when a financial institution lost money for the year.

That is why we believe we should apply basic standards to how we compensate people in our industry. In April, our firm made public a set of detail principles of compensation, which can be found on our website. We expect our shareholders to hold us to account on how we carry through these principles.

In short, we believe:

- oThe percentage of compensation awarded in equity should increase significantly as an employee's total compensation increases.

- oFor senior people, most of the compensation should be in deferred equity. Only the firm's junior people should receive the majority of their compensation in cash.

- oAs I mentioned above, an individual's performance should be evaluated over time so as to avoid excessive risk taking and allow for a "clawback" effect. To ensure this, all equity awards should be subject to future delivery and/or deferred exercise over at least a three-year period.

- oNo one should get compensated with reference to only his or her own P&L. Compensation should encourage real teamwork and discourage selfish behavior, including excessive risk taking, which hurts the longer term interests of the firm and its shareholders.

- oTo avoid misaligning compensation and performance, multi-year guaranteed employment contracts should be banned entirely. The use of these contracts, unfortunately, is a common practice in our industry. We should all recognize that they are bad for the long-term interests of our industry and the financial system.

- oAnd, senior executive officers should be required to retain the bulk of the equity they receive until they retire. In addition, equity delivery schedules should continue to apply after the individual has left the firm.

We believe attracting and retaining the best people is vital to our effectiveness and that incentives are an important element in that process. But we also recognize that, misapplied, they can also encourage excess. As an industry, we need to do a

better job of understanding when incentives begin to work against the public interest rather than for it and take action to redress the balance.

I do think it is important to recognize that while incentive structures should be improved across our industry, that is no panacea for poor risk management. More than a few financial institutions kept billions of dollars of assets on their books. Often, they kept those assets because they didn't know they were bad or toxic. Those institutions and the people that worked there – particularly at banks that failed -- suffered as a result. Thousands of professionals went down with the ship and lost much of their net-wealth as a result.

After the shocks of recent months and the associated economic pain, there is a natural and appropriate desire for wholesale reform of our regulatory regime. We should resist a response, however, that is solely designed around protecting us from the 100-year storm. Taking risk completely out of the system will be at the cost of economic growth. We know from economic history that innovation – and the new industries and new jobs that result from it -- require risk taking.

Similarly, if we abandon, as opposed to regulate, market mechanisms created decades ago, such as derivatives, we may end up constraining access to capital and the efficient hedging and distribution of risk, when we do come through this crisis.

Most of the past century was defined by markets and instruments that fund innovation, reward entrepreneurial risk-taking and act as an important catalyst for economic growth. History has shown that a vibrant, dynamic financial system is at the heart of a vibrant, dynamic economy.

We have to safeguard the value of risk capital, which is at the heart of market capitalism, while enhancing investor confidence through meaningful transparency, effective oversight and strong governance. If we fail to achieve this balance, we not only constrain our ability to finance ourselves out of the downturn, we weaken the elements of our financial system that, over the long-term, have contributed significantly to systemic growth and investment.

And that is why Goldman Sachs is committed to continuing to play a constructive role in regulatory reform in Europe and the United States. Thank you.