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NEEL KASHKARI:
LESSONS FROM THE FINANCIAL CRISIS

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Remarks:

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P R O C E E D I N G S

MR. WESSEL: Good morning. Thank you all for coming on such a beautiful day. I'm David Wessel. I'm director of the Hutchins Center on Fiscal and Monetary Policy, here at Brookings.

Once upon a time when people talked about fiscal and monetary policy, the phrase financial stability was either not mentioned, or if it was mentioned it was somebody else's job. But we learned the hard way, during the global financial crisis and the Great Recession that global financial stability is a really important public good, and like it or not, the Federal Reserve has some responsibility for at least minimizing the risk of financial instability.

I'm very pleased this morning, to welcome Neel Kashkari, the new president of the Minneapolis Fed, to talk about this subject. Mr. Kashkari has more experience in this than, say, your ordinary person on the street. As you know, he started as a Mechanical Engineer, ended up at Goldman Sachs, left Goldman Sachs because he talked his way into a job at the Treasury, with Hank Paulson, ended up running the TARP, the Troubled Asset Relief Program, made himself famous by being on TV defending it.

Because that wasn't enough fun, he went to PIMCO to start an equity fund there. PIMCO, as you know, is one of those places here you learn how people get together well to make money. After that he ran for governor of California against Jerry Brown, Jerry Brown won, in case you were wondering, 60/40, but he made quite a name for himself, as a Republican candidate who actually cared about people who make less than $3 million a year.

Neel is the new President of the Minneapolis Fed, and the Minneapolis Fed has a long tradition of thinking about financial stability in banking. You'll meet later, Gary Stern who was the President of the Minneapolis Fed for more than two decades, and in 2004, with Ron Feldman, wrote a book called “Too Big to Fail” that looked pretty good at the time, and looks even better from hindsight. I'm proud to say it was published by the Brookings Press. I'd also welcome Bruce MacLaury, a former President of the Minneapolis Fed, and a former President of Brookings.

Neel Kashkari is going to speak for a bit, then I'll be joined up here by Gary Stern; and Don Kohn, my colleague, and the former vice chair of the Fed. I'm sorry that weather has prevented both Sue Bies and Betsy Duke from getting here. It turns it was easier to get here from Minneapolis than from

Point South. Neel Kashkari?

MR. KASHKARI: Thank you, David, for the kind introduction. It is great to be back at the Brookings Institution. And I'd also like to thank the Hutchins Center for hosting us here today. I also want to thank all of you for coming out; you know we've got some tough weather. Washington has been hit a lot, and I really appreciate you braving the elements for those of you who are in the room, and our distinguished fellow panelists, Gary Stern, Don Kohn, Chairman Bernanke, and Bruce, our long predecessor as well. Thank you all for being here.

I just want to remind everyone that the views I'm expressing today are my own, and I'm not speaking on behalf of the Federal Open Market Committee or the Board of Governors, which sets regulator and supervision policy on behalf of the Federal Reserve System.

Today I will offer my assessment of the current status and outlook for ending the problem of too big to fail banks. I come at this problem from the perspective of a policymaker who was on the frontline responding to the financial crisis in 2008. When Congress moved quickly to pass the Dodd-Frank Act in 2010, I strongly supported the need for financial reform, but I wanted to see the Act implemented before I drew firm conclusions about whether it solved too big to fail.

In the last six years my colleagues across the Federal Reserve System have worked diligently under the reform framework that Congress established and are fully utilizing the available tools under the Act to address too big to fail. While significant progress has been made to strengthen the financial system, I believe the Act did not go far enough. I believe the biggest banks are still too big to fail and continue to pose an ongoing large risk to our economy.

Enough time has passed that we better understand the causes of the crisis, and yet it is still fresh in our memories. Now is the right time for Congress to consider going further than Dodd-Frank with bold, transformational solutions to solve this problem once and for all.

The Federal Reserve Bank of Minneapolis is launching a major initiative to develop an actionable plan to end too big to fail, and we will deliver our plan to the public by the end of the year.

Ultimately, Congress must decide whether such a transformational restructuring of our financial system is justified in order to mitigate the ongoing risks posed by large banks. Although too big to fail banks were not the sole cause of the recent financial crisis and the Great Recession, there is no question that their presence at the center of our financial system contributed significantly to the magnitude of the crisis, and to the extensive damage it inflicted across the economy.

Given the scale of job losses, home foreclosures, lost savings and costs to taxpayers, regulators and Main Street agreed with elected leaders that we must solve the too big to fail problem. We know that markets make mistakes; that is unavoidable in an innovative economy, but these mistakes cannot be allowed to endanger the rest of the country.

When roughly 1,000 savings and loans failed in the late 1980s, there was no risk of an economic collapse. When the technology bubble burst in 2000, it was very painful for Silicon Valley and for technology investors, but it did not pose a systemic risk to our economy. Large banks must similarly be able to make mistakes, even very big mistakes, without requiring taxpayer bailouts and without triggering widespread economic damage. That must be our goal.

Now since 2008, legislators and regulators have worked hard to address the too big to fail problem. My colleagues in the Federal Reserve System, working closely with other financial regulators, have implemented important tools and regulations that are making the financial system stronger.

Regulators have forced large firms to hold more capital and have deeper, more resilient sources of liquidity. Our stress tests check whether the most systemically important institutions can withstand a serious shock to the economy. In some cases, institutions have responded to these higher regulatory requirements by reducing certain activities. Considerable progress has been made, and these are steps in the right direction.

But regulators know that despite these best efforts, banks will still sometimes make mistakes and run into trouble. To ensure that banks can fail without requiring massive taxpayer bailouts, regulators are using the Living Will Review process to try to address the hurdles that make large banks so hard to resolve. They are establishing a resolution approach intended to give regulators the ability to restructure large banks without massive spillovers. And they have proposed requiring banks to issue debt that would help recapitalize the firm if necessary. All of these measures are sensible. Policymakers are committed to seeing these important efforts through.

The question is, should we be satisfied with this approach or should we do more? The lessons I learned during the 2008 financial crisis strongly influenced my assessment of new regulatory measures to address the too big to fail problem. I learned in the crisis that determining which firms are systemically important, which are too big to fail depends on economic and financial conditions.

In a strong, stable economy, the failure of a given bank might not be systemic. The economy and financial firms and markets might be able to withstand a shock from such a failure without much harm to other institutions or to families and businesses. But in a weak economy with skittish markets, policymakers will be very worried about such a bank failure. After all, that failure might trigger contagion to other banks and cause a widespread downturn.

Thus, although the size of a financial institution, its connections to other institutions, and its importance to the plumbing of the financial system, are all relevant in determining whether it is too big to fail, there is no simple formula that defines what is systemic. I wish there were. It requires judgment from policymakers to assess conditions at the time. I know this is unsatisfactory to many people, but it is the truth today. Perhaps one day we will have better tools to make this determination analytically.

A second lesson for me from the 2008 crisis is that almost by definition, we will not see the next crisis coming, and it won't be like -- it won't look like what we might be expecting. If we, or markets, recognize an imbalance in the economy market participants will take action to protect themselves. When I first went to Treasury in 2006, Treasury Secretary Henry Paulson directed his staff to work with financial regulators at the Federal Reserve and at the Securities and Exchange Commission to look for what might trigger the next crisis.

Based on his experience, we were due for a crisis because markets had been stable for several years. We looked at a number of scenarios, including a large bank, an individual large bank running into trouble, or a hedge fund suffering large losses, among other scenarios. We didn't consider a nationwide housing downturn. We didn't see it. It seems so obvious now, we didn't see it, and we were looking. We must assume that policymakers in the future won't see future crises coming either.

A third lesson from the crisis is that the externalities of large bank failures can be massive. I am not talking about just the fiscal costs of bailouts. Even with the 2008 bailouts, the costs to society from the financial crisis In terms of lost jobs, lost income and lost wealth were staggering; many trillions of dollars and devastation for millions of families. Failures of large financial Institutions pose massively asymmetric risks to society that policymakers must consider.

We had a choice in 2008. Spend taxpayer money to stabilize large banks, or don't, and potentially trigger many trillions of additional costs to society. A very crude analogy is that of a nuclear reactor. The cost to society of letting a reactor meltdown is astronomical. Given that cost, governments will do whatever they can to stabilize the reactor before they lose control.

Regulatory reforms since the crisis have focused both on making banks safer so they are less likely to fail, and on creating tools to resolve troubled banks by imposing losses on creditors without destabilizing the economy. Based on lessons from the recent crisis, I evaluate these restructuring tools by asking the following questions. Would policymakers responding to a future crisis actually use them? And how likely are they to be effective?

To answer these questions, I consider two simplified scenarios. The first, an Individual large bank runs into trouble, while the economy and financial system are otherwise sound and strong. And number two, one or more large banks run into trouble while there is broader weakness and risks in the global economy.

My assessment of these tools under the first scenario, the healthy economy scenario, is that they do have the potential to deal with the failure of an individual large financial institution without requiring a bailout or triggering widespread economic damage. But we don't know that for certain, and the work on these tools is incomplete and slow-moving.

For example, the reviews of the largest banks' living wills find that they have significant shortcomings, with the government requiring the banks to try once again to make themselves able to fail without massive fallout. Until this work is complete, which could be years from now, we must acknowledge that the largest banks are still too big to fail, And even then we won't know how effective these tools are until we have actually used them.

Unfortunately, I am far more skeptical that these tools will be useful to policymakers in the second scenario of a stressed economic environment. Given the massive externalities on main street of large bank failures in terms of lost jobs, lost income and lost wealth, no rational policymaker would risk restructuring large firms and imposing large losses on creditors and counterparties using the new tools in a risky environment, let alone, let alone a crisis environment like we experienced in 2008.

They will be forced to bail out failing institutions, as we were. We were even forced to support large bank mergers, which helped stabilize the immediate crisis, but that we knew would make too big to fail worse in the long term. The risks to the U.S. economy and the American people were simply too great not to do whatever we could to prevent a financial collapse.

I believe we need to complete the important work that my colleagues are doing so that, at a minimum, we are as prepared as we can be to deal with an individual large bank failure. But given the enormous costs that would be associated with another financial crisis, and the lack of certainty about whether these new tools would be effective in dealing with one, I believe we must seriously consider bolder, transformational options. Some other Federal Reserve policymakers have noted the potential benefits to considering more transformational measures.

I believe we must begin this work now and give serious consideration to a range of options, including: Breaking up large banks into smaller, less-connected, less important entities; turning large banks into public utilities by forcing them to hold so much capital that they virtually can't fail, with regulation akin to that of a nuclear power plant; taxing leverage throughout the financial system to reduce systemic risks wherever they lie.

Now options such as these have been mentioned before, but in my view, policymakers have not -- policymakers and legislators have not yet seriously considered the need to implement them in the near term. They are transformational and that can be unsettling. The financial sector has lobbied hard to preserve its current structure and thrown up endless objections to fundamental change.

And in the immediate aftermath of the crisis, when the Dodd-Frank Act was passed, the economic outlook was perhaps too uncertain to take truly bold action. But the economy is stronger now, and the time has come to move past parochial interests and solve this problem. The risks of not doing so are just too great. Many of the arguments against adoption of a more transformational solution to the problem of too big to fail are that the societal benefits of such financial giants somehow justify the exposure to another financial crisis. I find such arguments unpersuasive.

Finance lobbyists argue that multinational corporations do business in many countries and therefore need global banks. But these same corporations manage thousands of suppliers around the world. Can't they manage a few more banking relationships? Many argue that large banks benefit society by creating economies of scope and scale. No doubt this is true, but cost benefit analyses require understanding costs, too. I don't see the benefits of scale of large banks outweighing the massive externalities of a widespread economic collapse.

Some argue that if we limited U.S. banks in size or scope, they would be at a disadvantage relative to banks in other countries with looser regulations. If other countries want to take extreme risks with their financial systems, we can't stop them, but the United States should do what is right for our economy and establish one set of rules for those who want to do business here. Given the complexity of this issue, any bold plan will be imperfect, and there will be unanswered questions that skeptical experts can point to as a reason for inaction.

How can we precisely define which firms are dangerous and need to change? How can our plan adapt and endure as the financial system evolves over decades? What if strictly regulating some firms, just pushes risk onto other less-regulated firms? And how will new rules impact families' and businesses' abilities to make important investments; and what will that mean for employment and economic growth? Experts also correctly point out that there is always the possibility that an economic shock could hit us in the future that is so large, or so different from anything we have considered, that it overwhelms all of our efforts.

In that scenario, only the balance sheet of the federal government would be strong enough to stabilize the financial system, as was required in 2008. These are all important considerations, and there are many more. We must work to address them. But if we are serious about solving too big to fail, we cannot let them paralyze us. Any plan that we come up with will be imperfect. Those potential shortcomings must be weighed against the actual risks and actual costs that we know exist today.

Perfect cannot be the standard that we must meet before we act. Better and safer are reasons enough to act. Otherwise we will be left on the default path of incrementalism and the risk that we will someday face another crisis without having done all that we could to protect our economy and the American people.

As David said, the Federal Reserve Bank of Minneapolis has been at the forefront of understanding the risks and challenges posed by large banks and moral hazard for a longtime. Our work on these topics goes back to the 1970s, with specific work on too big to fail beginning in the 1990s. As

David noted, my colleague, Ron Feldman, who is here today, and one of my predecessors, Gary Stern, both authored the original book on this topic, Too Big to Fail; arguing in 2004, three years before the crisis, they argued that policymakers would not stick to their no-bailout pledges. They were right. Building on this important work, and the work done since the crisis, the Federal Reserve Bank of Minneapolis is launching a major initiative to consider transformational options and to develop an actionable plan to end too big to fail.

Starting in the spring, we will hold a series of policy symposiums to explore various options from expert researchers around the country. We will also invite leaders from policy and regulatory institutions and, yes, the financial sector, to offer their views and to test one another's assumptions. We will consider the likely benefits, costs, risks and implementation challenges of these options. And we will invite the media to these symposiums and live-stream them so that the public can follow along and learn with us.

Following the symposiums, we will publish a series of policy briefs summarizing our key takeaways on each issue, so that all can provide feedback. And feedback can start now. We have established a website where anyone can share with us their ideas on solving too big to fail. If you are a researcher, if you work in the financial sector, if you just have a good idea for solving too big to fail, wherever you are, share it with us at MinneapolisFed.org.

We will use all of this work to inform our plan to end too big to fail, which we will release by year-end for legislators, policymakers and the public to consider. Congress created the Federal Reserve System to help prevent financial crises from inflicting widespread damage to the U.S. economy. Doing everything we can to address the systemic risks posed by large banks will be an important step to fulfilling that mission. Seven years after the crisis, I believe it is now time to move forward and end too big to fail. Thank you very much.

MR. WESSEL: Thank you very much. Thank you very much, Neel Kashkari. Certainly, starting your tenure as president of the Minneapolis Fed by giving us something to think about, it would take you a long time to learn how to give a speech as the Fed President, where no one understands that you are saying. So, I'm glad we got you before they trained you.

I want to start, Neel, by asking you a question, and then turn to Gary and to Don. The

Dodd-Frank Act begins, "To promote the financial stability of the United States, by approving accountability and transparency in the financial system, to end too big to fail, to protect the American taxpayers by ending bailouts, to protect consumers from abusive financial practices, and for other purposes." And your argument basically is, we did not go far enough. Correct?

MR. KASHKARI: That's correct. Yeah. I think we -- A lot of Dodd-Frank has done good, and the financial system is stronger today, but I do not think we've gone far enough to end too big to fail.

MR. WESSEL: Okay. So, Eric Rosengren at the Boston Fed gave a speech the other day in which he made two points. he said, "One, we have reduced the probability of failure; and two, we have reduced the cost of failure by forcing the banks to have more capital, and have more depth, they can be bailed in before the taxpayers are." Do you disagree with those assertions?

MR. KASHKARI: I agree with the first assertion, that we've reduced the chances of large banks running into trouble. But when I think about the cost of failure, it's not simply the cost of the bailout, it's the economic damage that it's inflicted across society, and so, you know, think about an analogy, I used the nuclear reactor. Think about the Fukushima disaster. You know, they built the wall so high to try to prevent a tsunami from flooding, well the question is not -- One question is, is the wall high enough? The second question is, how devastating is it to society if the reactor floods nonetheless? And I don't think the second point that we have, dealt with it adequately.

MR. WESSEL: Okay, Don? What do you think? Do you agree with him, or not?

MR. KOHN: No. So, I think I certainly share Neel's objective of this, ending too big to fail, that is allowing any large financial institutions to fail with minimal damage on the financial system and on the economy, absolutely, have to do that, that's part of the market system. If you are playing in the market system, you've got to be ready, not hearing huge profits but to fail, and knowing that your shareholders and creditors have to be ready to lose their money.

So, we share a goal, you start from a premise, as you've just answered David's question, that we haven't done enough. And I guess I'm not sure. So, it's possible, but I'd like to hear more of your arguments about why the authorities won't use the neutrals they were given. I mean one of the lessons was one reason that we to intervene the way we did, and I say we, because Neel and I were on, basically, the same team trying to save the system, was because we didn't have enough tools.

The system was too fragile, we've done a lot about that, and we didn't have enough tools. Now you have the resolution regime, Title II of Dodd-Frank, so you apparently don't think that's going to work, and you don't think people, the authorities will use it. So, the Congress has attempted to certainly wall off the things that the authorities did to save the big banks, before. I don't know why those won't work, I assume the authorities won't have to go back to Congress for another TARP, I think it will be several generations before that's possible, so this thing better work, and I think it has.

So, I think the authorities will use the new resolution, or I'd like to be convinced about how they could get around it, and then I think the new resolution's regime wants it fully in place, probably will work. So the probability is big right there, but I think there's a lot of bailing in certain creditors, putting them at risk, using that capital to capitalize the operating subs, the systemically important parts, restarting the thing. I'd like to hear why you think that's not going to be sufficient in the next crisis for -- if there's more than one institution threatened at the same time.

I don't know. I mean, there's a lot of stuff being done, but I think it stands a good chance, and I think you have to -- before you say, let's break up the big banks, let's use government to intervene in the private sector in a way that's pretty major. That is taking a private entity and breaking it into different pieces. I think you have to convince me that what's been put in place won't work.

MR. WESSEL: Gary, do you want to comment, and we'll let --

MR. STERN: Yes. I think I largely agree with Don. I think the key in the current legislation to effectively dealing with too big to fail is the living will process. And frankly I'm comforted by the fact that none of those proposals have been approved yet. Because I think they are very difficult to do well, and if they had been approved, I'd be suspicious that they really weren't of adequate quality and wouldn't be effective.

But I think it's a big mistake, to dismiss that, or to underrate the potential of the living wills. First of all, that are mandated by Congress, and the regulators have to improve once they are acceptable. It doesn't require any additional legislation; it doesn't require getting into political battles about who ought to do what to whom. It's in place. And if they've done well, then their design to limit spillovers from a problem at one or more major financial institutions, so that contagion effects, the effects on the overall economy are manageable, that's what they are designed to do, and therefore you don't need the government to intervene to protect uninsured creditors or others.

Now, it's a -- The jury is out, it's not obvious that this is going to, that the proposals, once they are in place, will be adequate, but I don’t think there's any reason to start with the presumption that they won't be. After all, the regulators are on the hook to get this right.

So I think that’s absolutely critical, I think there's a lot of promise there, I think the jury is out, but if it's put in place appropriately, and if it's communicated to the public appropriately, and in particular to uninsured creditors, and shareholders appropriately, then you should get different pricing in the marketplace of risk-taking, better pricing, and sounder institutions going forward, simply because you have credible plan in place. So, frankly, I think there's a lot of potential there, and if I were still playing in the policy game, that’s where I would start, and that’s where I will put my emphasis.

MR. WESSEL: So, Neel, you don't think the jury is out. Or at least you know what the jury's verdict is. What makes you so sure that the system won't work as Title II of Dodd-Frank, and as the living will suggest?

MR. KASHKARI: Well, it comes back to what contagion is. So, imagine you are in a stressed economic environment, and several big banks are under stress at the same time, and you are a creditor of one of those banks. So, that bank owes you money, you are a bondholder. And another bank that looks just like your bank, all of a sudden their debt was converted to equity. Their bondholders are not happy in that environment to not have debt, to now have equity in the bank.

The last thing they want in that environment is the equity of that bank right now. They want their money back. So if you are bondholder of another institution, that looks a lot like that first institution, what are you going to do? Get out, if it all possible. And so the contagion risk is the thing that was so -- And Don, you know this as well as I do, was so devilishly hard to deal with during the last crisis, and I'm not suggesting that we are going to come up with a plan that’s going to solve every economic scenario, every shock no matter how big, but look at the environment that we are in today.

We are in a global economic environment where there's some stress, there's increased volatility, some bank shares especially in Europe, have come under trouble. I mean, Don, remember when you were there, do you really think in 2008, if you had the ability, if the Federal Reserve had the ability to say, we are just going to haircut these bondholders from one bank, you would have pulled the trigger? I don't think so.

MR. KOHN: I think if the system had been put in place a number of years before, and bonds had been issued with the explicit promise that they would be haircut under these circumstances, I think we certainly would have tried it first, and then those bonds become equity, so the rest of the organization is much safer. The runs were on overnight funds, and bailing in these long-term creditors protects the short-term creditors. And that's where the danger was.

So I think if there's ways of doing that, and I think the market is beginning to believe this. Look at what's happened to the CoCos in Europe and the prices of those and subordinated --

MR. WESSEL: The CoCos are these contingent bonds that --

MR. KOHN: That become equity when capital drops to a certain level, and the turmoil that Neel is referencing in banking markets over the last couple weeks. The CDS, the risk premium on bank bonds, and the prices of these convertible bonds, have really been affected. So, it feels like the market believes, the authorities will at least use of these creditors to increase the equity of the banks. Now, I think, as you said, in your speech, we are not all the way there, in the living will process, needs to work out the total loss-absorbing capital.

How much of this credit should be out there that can be converted? Is it high enough to protect the taxpayers? Are there systems in placed at the FDIC, the bank of England, the European Central Bank to wind down these institutions, and put them in receivership in a safe kind of way, those are still works in progress.

MR. KASHKARI: Let me ask a follow up to Don, so I like the conceptual concept of the TLAC, total loss-absorbing capacity -- the bonds that convert equity, with the explicit intention of recapitalizing the firm. Why be cute about it? Why not just raise capital requirements? Why not just make it equity, so that there's no confusion. Because I look back in '08, these big banks also issued SIVs, remember the structured investment vehicles, we had no legal obligation to bail out their SIVs, they ended up having a reputational obligation to bail out the SIVs. So the legal framework became irrelevant, it just became what their customers expected. How do we deal with that?

MR. WESSEL: So, Gary, do you think more -- even more capital on the big banks is a good idea?

MR. STERN: I don't think it's necessarily a bad idea, but I don't think by --

MR. KASHKARI: Not exactly ringing your door (crosstalk) --

MR. STERN: I guess -- I don't find it by itself to be obviously sufficient. Or let me put it this way. It doesn't take advantage it seems to me of other improvements we can make. And I wouldn't put all my eggs in just one basket. And so I think there are a number of things that can be done. We've already talked about some of them. Another thing that we haven't talked about, and I'm sure this is going to sound mundane, and maybe inside baseball to some people, but in my experience, senior bankers, are willing to push back and/or ignore, regulatory pressure.

They are much less likely to do so, when they are getting it from their boards of directors. And I think that's an avenue that has been under-utilized to date. And I think there are some obvious this that can and should be done here, in some cases they have been, but not in all, and perhaps not in many. For example, you should have an independent chairman; that is the CEO of the institution should not also be chair of the board of directors.

You should have a fair number of independent directors, who should probably have term limits for directors, so that they don't get captured by management, et cetera, et cetera. This is all corporate governance stuff, but it seems that my judgment ought to be done because it will -- no, it has the potential to improve the situation at relatively low cost. So I would go down that path as well. Another path in Neel's remarks he talked about parochial interests.

You know, parochial interests are obviously in a lot of places, one of which is turf battles among the regulators. And Paul Volcker has been working on this issue off and on for decades. I'm tempted to say, I'm going to exaggerate the situation a little bit, because I don't quite mean it, but our current regulatory structure with, you know, the Fed and the OCC and FDIC and the SEC and the CFTC, and I could go on and on, it's inefficient, ineffective -- that's not fair -- it's not as effective as it could be, and it's indefensible.

Then why don't we fix that? Well I mean, we all could drum up three or four reasons of why we don't fix that. And will it solve too big to fail? No. Will it help? Lead to a better regulated, supervised financial system? Yes. Does it illustrate parochial issues and the difficulty in dealing with them? Yes.

MR. WESSEL: Neel, how do we know that the problem is solved? What indicators would tell you we've pretty much gone far enough to deal with the too big to fail problem?

MR. KASHKARI: Well one way, and this is obviously a very hard thing to know for sure. And again, I want to reemphasize that we can never eliminate all risks.

MR. WESSEL: Right.

MR. KASHKARI: There is always the risk, that a shock comes that's so large that we --

MR. WESSEL: Right. But you are saying we haven't eliminated enough.

MR. KASHKARI: (Inaudible) -- You know, I was reading up, it's funny, as I was preparing for this, I actually this nuclear reactor analogy is a decent one, and I was reading up on the --

MR. WESSEL: I'm sure the banks really appreciate your frequent use of --

MR. KASHKARI: I know. I know. I'm sure they appreciate this whole discussion. But the reports on the Fukushima said, do you know what, they should have done more homework. Actually there has been a tidal wave this large in the large in the last thousand years. A report I just read, there has been a tidal wave that large, evidence of one in the last thousand years. Now I'm not saying we have to prepare for a shock that comes one every thousand years, but we just had a big shock.

We had one 80 years ago in the Great Depression, those are two big shocks. Should we build the financial system that's strong enough to hit a shock, that we are pretty sure is going to hit us once every hundred years. That's a pretty ambitious goal, but I'd like to at least go for it; even if we can't there let's at least try.

MR. WESSEL: How will we know? I mean, we've seen for instance, the rating agencies from, for whatever value they have, are beginning to believe that governments will not bail out the banks. We are dong stress tests, is it that the -- if we make the stress test scenario more severe, that we'll be more confident that we are there? How will you know when we have gone far enough?

MR. KASHKARI: I wish I had a precise answer. You know, this is the nature of risk, we are all -- In fact, another analogy which I'm sure the banks are going to love; is think about airport security, we are always evolving airport security over the last terrorist threat. So we all take our shoes off, and we go through X-ray machine, right. Does it make us any safer because we take our shoes off? No; because the next attack is going to look different than the prior attacks.

And so it requires judgment, and I'm just sharing with you, that based on my experience in '08, looking at the types of things that we've dealt with, I don't think -- feel like we've done nearly enough. You know, another analogy -- Do you remember Norman Schwarzkopf, the General who ran the first Gulf War? I saw this interview with him, when he said, preparing for war is like planning an orchestra. You have all the instruments finely tuned, everyone is practiced, everyone is rehearsed, everyone knows their part.

The curtain goes up, and he's conducting the orchestra, and a mad man jumps up and starts chasing around the stage with a machete. That's what he said war was like, and so all of these pieces that we are putting in place right now, are eminently sensible. They are steps in the right direction, but what happens when the shock hits us, that is unlike anything that we thought of.

Are we at least -- We should at least be honest with the American people, and say, hey, this could happen again. We are doing things that we -- we are doing sensible measures in the right direction, but we want to be honest with you, that this could happen again.

MR. STERN: You know, we've all been expressing, or Don and I have been expressing reservations about what Neel has proposed. But let me say, I mean I think what he's got here is thought-provoking and provocative, and worth consideration. And let me also add, that if this effort, going forward, to come up with something before the end of the year, is effective; you know, at least it provides a sense of urgency to dealing with the issue.

And you know, one of the things we are, what, six years past Dodd-Frank. It doesn't strike me as entirely acceptable that we are still working on the details of all of this. I mean, I know what the reasons are on the -- I know what the stated reasons are, but if there was a real sense urgency here, I think we'd be further along.

MR. WESSEL: I should remind people, we'll have some questions in a bit, and if you use the hashtag on the Fed, one of Neel's colleagues in the Minneapolis Fed is monitoring Twitter, #FedFinancing, if there are questions from that we'll get them through that route.

Two questions, Neel. So, Congress said it doesn't want more bailouts. Congress has limited the ability of the Federal Reserve to do what it did in 2008, it has given the FDIC, for better or worse, powers and the FDIC is developing these powers. Are you saying in a crunch, the Fed lawyers, and the Treasury lawyers are so good, they'll find a way to evade the rules, that Congress set up -- which is a possibility? Are you suggesting that we'll be once again, in the middle of the night, the Chair of the Fed, whoever it is, go into Congress on bended knee, and said, please, I need TARP 2.0?

MR. KASHKARI: I think it will depend on the situation, but first of all that the idea, I know many of my Fed colleagues have said this, the idea, we all hate forest fires, so let's take the hoses away from the fire fighters, that's not the solution to ending forest fires. The tools that we've utilized in '08, both at Treasury and at the Fed, and ultimate with the TARP authority, were crucial to stabilizing the U.S. economy, absolutely crucial. So that's not the right solution.

The right solution is to take action to make sure that that the system is stronger, and to give -- to take the bold action now in advance. And so, you know, I think, when I ran for office, I used to joke that the first thing I was going to do as Governor is ban traffic. It's easy to just make a declaration that -- We've banned this. There can be no bailouts. There can be no traffic. Well, is actually how the world works, and in the reality we are living in today, we need to be honest with one another, about the risk that we still face.

MR. WESSEL: And do we have anything to learn from how other countries are handling the situation, the Swiss, the British, and so forth?

MR. KASHKARI: Well, I'd be interested in Don's views because, you know, Don is obviously involved in the U.K. My assessment is that they seem more comfortable having these major risks in their financial systems, in their economies. I mean, their banking sector, in many cases, has a percentage of GDP, are larger than our banking sector as a percentage of GDP, and so I feel like we are actually further along in some cases than they are, but I'd love to hear Don's perspective on that.

MR. WESSEL: The Swiss have added a lot of -- have required much more capital from their very big banks, which are much bigger relative to their economies are. The British, after they got done nationalizing all the banks, have talked about restricting what banks can do, right?

MR. KOHN: Well, what we and the U.K. have done, is we've --

MR. WESSEL: Don is on the Financial Policy Committee of the Bank of England, because the British think you can learn something from foreigners, which does not seem to be an American tradition, at least not since the revolution.

MR. KOHN: So in the U.K. we have increased capital requirements, quite considerably, including in the process of increasing them on the globally systemic, globally important banking institutions. I would say, just a little sidebar, if anything, the fact that the banks are much bigger in proportion to GDP in the U.K. and the U.S., makes the U.K. more intent on dealing with this.

The second thing that's happened is ring-fencing, so they've said, the Independent Commission on Banking which was convened by the Parliament, I guess four, five years ago, after the crisis, said, one way of dealing with this, too big to fail issue is, let's take the parts of the bank that are really systemically important, the ones that take deposits and make loans, to consumers in small businesses, the payments run through, let's ring-fence them, let's take them apart, take them, make them separate institutions within a bank holding company, and hold them to higher capital requirements.

And that's in the process of being implemented. I would note that that's kind of like the U.S. system, so we have bank holding companies, we have depositories that are separated from the investment banks, and the Federal Reserve Board has put higher leverage requirements on the depositories than on the holding company, so there are considerable similarities.

I think the other thing the British are doing, is they are taking this resolution thing very seriously. And the living wills, but also, we, on the Financial Policy Committee, are considering how much of this total loss-absorbing capital is required. We are trying to run cost benefit analysis about, to your point Neel, how much equity, how much debt, and we came out with a number for equity. We thought balanced the cost of benefits there, and then we were going to put the debt on top of that. So, basically the British are doing the same things that are happening here, but I would say, if anything, they are more concerned about this than maybe the U.S. should be, given how big the banking sector is.

MR. WESSEL: Neel, you correctly observe that the cost of another financial crisis is enormous. And so therefore the benefit to avoiding one has to be pretty big. But one hears quite a bit these days, that one reason the U.S. economy isn't doing better, is because we have made the banks too risk adverse, that the proliferation of bank regulatory agencies that Gary Stern only partially listed, we could have added the Consumer Financial Protection Bureau, and then whenever these guys don't do their FSOC, the Financial Stability Oversight Council wants to do, is causing us -- is hurting us in economic growth. You take that, those warnings seriously, or do you just they are outweighed by risk of another crisis.

MR. KASHKARI: No. I do take them seriously, and I'm very sensitive of that, especially the small banks, the community banks are -- though it's not the intention of regulators, they are being caught up in the regulatory net that's focused on the largest banks. And so if we took a more aggression action, to make the large banks safer, then perhaps we could relieve some of the burden, across the system, and maybe free some of the community banks, from some of the regulation, so that it's easier for them, to lend to families and the small businesses. So I take that seriously and I think that we can address that as part of the solution that I'm hoping we can come up with.

MR. KOHN: I'd like to pick up a point that Gary made, and then come back to the British-U.S. thing. So Gary's point about the fragmentation of organizations of the regulatory structure in the U.S., I used to think that we kind of lived with it, and there were people who worked, but I don't anymore. So I think it's a very serious problem. One reason it's taking so long for the Dodd-Frank Rules to be put in place is it requires cooperation among all these agencies, and they each have a slightly different perspective.

And then finally I think the organization, one big way in which the U.K. is organized different from the U.S., and I should have said this right away, is the Financial Policy Committee. So there is a committee with -- a little bit like FSOC, but doesn't have 10 agencies sitting around the table, focused entirely on the systemic risk and the resilience of the U.K. financial system to a tidal wave, to a serious tale event.

And we've been given the tools, including in residential real estate, which aren't really here in the U.S., and capital, liquidity to do this. Now whether we'll be successful over time, only time will tell, and events will tell, but I do think the U.K. is much better organized to keep the system safer than the U.S., with all these warring agencies, many of which don't have an explicit financial stability mandate.

MR. WESSEL: Gary, do you take seriously the claims of the banks, and others that all this regulation and cacophony from the regulators is hurting the economy?

MR. STERN: Only partially, at best, for a couple of reasons. I agree with Neel, and it doesn't make a lot of sense to me to include community banks, and in fact, I understand clearly are not systemically important in the same umbrella. I mean, that's a waste of resources, in lots of different ways, and we ought to -- we are certainly smart enough to fix that. But we see after every recession a reaction from the regulators, which is to tighten things in the financial services industry, and then that's always followed by concerns that maybe in some cases, reality of, well, now credit is not available even to the quality borrowers, et cetera, et cetera.

And then people get over it, and life goes on. And we've seen that -- we've seen that before, and I think we are seeing that again. I think the best way, and these are not mutually exclusive, but I think the best way to understand what's happened to the U.S. economy in the wake of the financial crisis, is Reinhard and Rogoff. I think, you know, they wrote -- For those of you who aren't familiar with their book, I think it's called This Time Is Different, that's tongue n cheek, and they wrote a book, the message of which is, and they've done extensive historical research across countries, across time periods, et cetera, et cetera.

The message of the book is, economic recoveries following a serious financial crisis turn out to be frustrating, disappointing, substandard, et cetera, et cetera, not wholly independent of what policymakers do, but largely independent, and apparently it's the hangover of the financial crisis. So if I were trying to understand the performance in the U.S. economy in the last six, seven years, that's where I'd start.

MR. WESSEL: You know, let me ask you one final question before we turn the audience, and that's about the politics of making a speech like this now. I mean, there are lines in your speech that I can imagine Bernie Sanders or Elizabeth Warren saying, it's not what one expects from a Goldman Sachs Republican who is responsible for ripping up the taxpayers during TARP. (Laughter)

MR. KASHKARI: We made a profit, the taxpayers made a profit, and to just point that out.

MR. WESSEL: I'm curious, what's going through your mind, what led you to decide that a couple of months into the job that you wanted to start playing in the sand box, and be as provocative as—

MR. KASHKARI: Well, you know, I was interested in this, in joining the Minneapolis Fed, because I wanted to take on the biggest economic and financial challenges we have as a country, and I didn't know what those challenges would be, and when got to the bank, I found a lot of expertise on too big to fail on large banks, and bank regulations. And so I started talking to my expert colleagues, about my ideas, some of the concerns that I had.

You know, when I first wrote about this, I gave a speech at the Chicago Fed in 2011, where I said -- right after Dodd-Frank was passed -- I said, here are some of my concerns, let's not declare victory. We've got more to learn, we've got more work to do. So those ideas were still in my head, and as I got into the bank, I started talking to the experts and testing some of my ideas, some of my assumption, and I realized, wow, there are still big risks, here, and if I'm not willing to -- You know, the Fed's core mission is financial stability, that’s one of the Fed's missions.

If I'm not willing to stand up and share my concerns, then I wouldn’t be doing my job. And so that’s what's motivating it. That’s when I actually wrote the first draft of this, at least the concept for it, in December, before I even had started at the bank, and I wanted to get my colleagues' reaction to it. And then here we are.

MR. WESSEL: Yeah, let's take some questions. We have mics going around, and I'd like people to stand up if they have a question, ask it, remember it's a question, and tell us who you are. Why don’t we start over here?

SPEAKER: Hi. Thank you very much. (Inaudible) in New York City. I would like to ask you, regarding the relation between debt and inflation. Like you go to (inaudible) published very interesting piece of research, showing how the global debt has been rising from $150 trillion, up to $200 trillion. I would like to ask you, regarding a new environment where we are seeing deflation in many OECD countries; do you think that this more complicated possibility of earning this debt for the debtors, in real terms, is going to be a challenge for the financial sector -- security?

MR. WESSEL: But Mr. (Inaudible), you are asking; if we are in a period of very low inflation, or falling prices, deflation, doesn’t that make the debt problem even worse?

SPEAKER: Exactly.

MR. KASHKARI: There's no question, if we were in a situation of deflation, that that would be -- part of the problem with deflation why it's so painful for economies, is exactly that, it makes the debt overhand so much worse because the debt grows in real terms. And so I think central banks all around the world are absolutely committed to achieving their inflation targets. In the Fed's case, it's the 2 percent target that we have established.

MR. WESSEL: Ben Bernanke?

MR. BERNANKE: So all of your calls before, it's more study, and academics can always be in favor of that, right? Let me make an argument on your side and see if you agree with it. There's a lot of folks even on the FOMC who think that interest rates are being managed in part, to avoid financial instability. You know, interest rates too low for too long, those sorts of things. And it strikes me that the decision to move monetary policy in ways which are inconsistent with the near-term, employment and inflation mandates, is actually, potentially a very big cost, that people are undertaking because they are worried about the implications of debt buildup and so on.

Would you take that, would you agree with that, would you agree that's an argument in your side that, you know, structural change is better, potentially, than using monetary policy to try to make the financial stability goals?

MR. KASHKARI: I think, absolutely, I agree with that. Before I joined the Fed some of my now colleagues on the FOMC went -- Some of the Reserve Bank Presidents, read a scenario, a dry run of, imagine if there was a bubble that they saw coming, what tools could they use? And they found themselves very limited in having to go with the monetary policy tool, potentially to try to deflate that bubble, which is a very difficult thing to do, because you can't target it

And so I think if we can make the financial system stronger on its own, in some sense we are leading some of the burdens on the monetary policy process, so they can really just focus on dual mandate. Otherwise, some people argue we have too mandates, right? The dual mandate instead of just an inflation mandate; well now we have a dual mandate and a financial stability mandate, and as you've said, Chairman Bernanke, there are times when those things are in conflict with one another, so I do agree with that.

MR. WESSEL: Don or Gary, do you do you want to?

MR. KOHN: Well, that's exactly why, one reason I worry that the U.S. isn't as well organized for so-called macro-prudential policy, policies that could lean against using regulation, supervision and rules, lean against buildups of imbalances in the financial system, because I think it would put more pressure. I'd prefer to do that, before monetary policy. So I think another response to your concerns, Ben, would be to do something about the regulatory system, build up the macro-prudential capabilities in the U.S., and organize them better.

MR. STERN: Well, for better or for worse, I don’t necessarily agree with that, and I'm on record of one of the last things I wrote when I was still at the Minneapolis Fed, was trying to raise the issue of, should you use monetary policy to deflate asset price bubbles? Recognizing of course that identifying a bubble is not the easiest thing in the world and, Ben, I suspect Don is quite uncomfortable with that, maybe Neel is, and I gather Ben is, but it's a cross benefit thing. It's the same thing that Neel was talking about earlier.

I mean, given the cost of the financial crisis, and looking back at it, it seems to me it was worth asking the question. Should monetary policy had been more restrictive, say, higher nominal interest rates, how everyone would define it, prior to the crisis, because the cost of the crisis turned out to be so great. And I don’t think you can just dismiss that. There may be better ways of addressing it, although frankly I've yet to hear a clear definition of what macro-prudential regulation is, much less how effective it might be. But I don't think you can just dismiss it, because the cost of -- its cost benefit, and the cost of the last financial crisis were (crosstalk).

MR. WESSEL: I think the argument is, not that it should be dismissed, but it's not a good place to be if that’s our first option, because it would involve raising interest rates so much, in order to burst the bubble, that we would rather have some other tools to do it. You are suggesting macro-prudential is a nice way to describe something that we don’t understand?

MR. STERN: Yes. And I'm also suggesting that we don’t know how much it would take to raise interest rates. You know, if one of my former colleagues was sitting here, a couple of my former colleagues were sitting here, I don’t want to put words in their mouths, so I won't identify them, but I think they would say, well, you know, the surprised increase in interest rates would have a big effect, surprise increase. Now that, the Fed has worked very hard at transparency, at helping market participants understand what's coming, and if possible when it's coming and so forth, but that’s not the only view of policy, so you know, let's have the cards on the table.

MR. WESSEL: Okay. I think there's a question in the back.

SPEAKER: Thank you, sir. I really like the metaphors that you used, the nuclear reactor, fire hoses, and things. But I had to ask a question about where we still are since 2008, I think -- Do you believe that the economy is still on life support, because we are still having to keep the interest rates low and in fact, we are still having to do the -- money being pumped into the system? Do you believe that is still the case, or do you think that is going to be changing soon?

MR. WESSEL: Okay. Let's take another one; the gentleman over here?

SPEAKER: So, it took three years, or four years for real estate prices to drop by a third, because there was so much time involved in that, we were able to build paper on paper, and it created a huge worldwide economic crisis. The banks proved that they could do it again, in six months, where they were lending aggressively to the oil patch, at $100 a barrel, six months later oil dropped 75 percent, but because they didn’t have enough time to build that into a huge worldwide thing, where there was paper built on paper, and so on, it seems like the crisis is not quite the equivalent.

But my question is, about the only thing we've seen out of Congress is they took the money, the slush fund money that the Fed had, that helped solve and stabilize the last time around, they took the money to use for the highway bill instead. And I'm wondering, how important do you think losing that emergency tool may prove to be?

MR. WESSEL: Okay. Take one more, the gentleman here.

SPEAKER: I speak as a layman. On the street, we still believe the big banks will be bailed out, and --

MR. WESSEL: Those (inaudible)?

SPEAKER: Yeah. Dodd-Frank is still fighting the last war.

MR. WESSEL: Okay. Two questions and a comment; let's start with the -- Don, and maybe you can help clarify this. Does the Fed have the financial capacity to deal with the crisis, if one occurs, despite what Congress did on the highway bill?

MR. KOHN: Yes. So, I think, I wouldn’t characterize the Fed's capital as a (inaudible) run. It's an entry on a balance sheet; the capital itself didn’t really play a role in any of the things that the Fed did. Now, I don’t think Congress should be just taking that capital without a careful consideration of what the whole structure of the Federal Reserve should be, and how it should be capitalized, et cetera. So, I don’t agree that taking that was a great idea, a good way to finance highways, or better ways to do that.

But I don't think that by itself doesn't affect the Fed's ability to do other things, make loans, in particular in a crisis. I think Congress has constrained that, particularly loans to non-banking institutions, it has to get the permission to the Secretary of the Treasury, there is a lot of emphasis on security, and there's a lot of transparency, that I worry about some of the restrictions that already are on the Fed's ability to take loans, but has absolutely nothing to do with the highway bill.

MR. WESSEL: And Neel, do you think it's correct to characterize the U.S. economy is still on life support, and demanding lots of support from the Fed?

MR. KASHKARI: No. I think we've come a long way since the depths of the crisis in '08 and '09, and the economy is fundamentally stronger, and if you look at the FOMC statement in January, those might have been the FOMC meeting, that was my first but --

MR. WESSEL: Did you say anything?

MR. KASHKARI: I did. I did. Can you imagine me being quiet? No. The Committee's judgment is that the economic outlook is for moderate economic growth, and if the outlook is -- if the reality ends up like the outlook, then I think we are going to be heading in a better direction.

MR. WESSEL: Over here?

MR. CHECCO: Thank you very much. Larry Checco with Accountability Essential. A lot of interesting points here, but I'm going to go one step further. I think the regulatory agencies failed this miserably in this last crisis, and do you believe that they've been rehabilitated enough to, you know, get us through another one? But my real question is -- (Laughter)

MR. WESSEL: That wasn't a real question?

MR. CHECCO: My real question is, are we over-engineering these regulations? It seems to me that maybe people who should have looked up the beyond their computer miles, and actually seen what was happening going on the ground. The pricing was going up immensely; wages are flat, terrible mortgage rates were being -- nobody questioning any of that. So maybe we have to inject more commonsense than regulation into this equation. Thank you.

MR. WESSEL: The gentleman behind you?

SPEAKER: Thank you. (Inaudible), the Japanese Embassy. And I have a question to

Neel. You said that transformational, what are options are necessary, each to include those breaking up a lot of banks, but I think Dodd-Frank have to already give -- regulate the authorities to break up the larger banks, in case living wills -- their living wills insufficient. But do you think the other -- Do you think the further legislative authorities necessary for the (inaudible)? And could you explain about what kind of authorities who are legislative measures --

MR. WESSEL: Okay. Just so I make sure I got it. You are saying that the regulators already have some authority to break up the big banks, is he suggesting that they use that authority, or are you suggesting they need new legislative powers. Do you want to take those two?

MR. KASHKARI: Sure. My view is to do anything transformational system-wide we would need new legislation. I agree that the authorities the ability within the living will framework, the FDIC and the Fed working together to target individual institution, but my read at Dodd-Frank as I watched the debate, I don't think -- my personal opinion -- I don't think the intention of Congress was that Dodd-Frank was meant to be a tool for transformation of the financial sector.

I think a transformational solution is something that, it is absolutely appropriate and necessary for Congress to weigh in on, and take an active role in deciding what that transformation looks like, rather than using one little tool over here, and trying to use that across the whole system.

MR. WESSEL: Yes. I think we have some questions from Twitter that Paul Wallace is going to read.

MR. WALLACE: Thank you, David. A theme that's being talked about is the difference in treatment between the large banks and the small banks, and a question that, "Isn't there still contagion risk among small banks if a number -- if many of them are involved, how do those risks weigh against the risks faced by the large banks?"

MR. KASHKARI: What I mentioned in my speech was, when you look at the savings and loan crisis, you had a thousand small banks fail, and now it's devastating for those banks and for their communities, and that's not a good thing, I'm not saying we should celebrate that, but there was no broader risk of economic contagion in economic collapse. And so to me, if we are in a -- if we can get our financial system in a situation where we can take on major shocks, without requiring taxpayer bailouts, and without triggering widespread downturn, that should be our goal.

MR. KOHN: There was a recession, right?

MR. KASHKARI: Understood.

MR. KOHN: After the thrift -- I mean, it was more than the thrift, right, so the banks, some of the banks got in trouble, but there was a recession, and the recession was prolonged and the recovery was damped by the credit restrictions that occurred after that. So I guess I'm not -- If you took a big bank that was systemically important, and broke it up into eight smaller banks, that each have the same balance sheet --

MR. KASHKARI: And the same strategy?

MR. KOHN: The same strategy, you wouldn't be doing anything, right?

MR. KASHKARI: Agreed. If you break it up and there's no change in their business models, and there's no change in behavior, but when you have covert governance that Gary talked about with different CEOs, and different boards of directors, and there are different geographies, that's probably not the situation that we are going to end up in. And by the way, I'm not -- this whole process I'm not saying that break up the banks is necessarily the right solution, it's one of the solutions. If you took all the big banks and you stuffed 25 percent capital in them, they are going to be a heck of a lot stronger than they are today, and be able to take a much bigger wave.

MR. STERN: I'm not persuaded that, even though a large number of community failure, or even a large number of community banks would pose a systemic risk to the financial system or the economy. Community bankers sometimes like to invoke that for level playing field considerations, et cetera, but I don't find it convincing.

MR. WESSEL: The woman in the brown, can you stand up so the mic can find you? And then there's a gentleman on the aisle in the orange shirt.

SPEAKER: Full disclosure. I was one of those regulators a long time ago. I was not in the most recent crisis, but I was certainly involved in the New England commercial real estate crisis. I think one of the things --

MR. WESSEL: Which regulator did you work for?

SPEAKER: I was with the SEC. I think one of the things that needs to be addressed, and you were kind of circling around it, is banks fail for two reasons, they fail illiquidity, and they fail for lack of capital. Of course capital is assets minus liabilities. In terms of systemic risk, when you have assets that are concentrated, you have systemic risk, whether that's across a variety of small institutions, or concentrated amongst large institutions.

I think one of the things that you haven't addressed, you mentioned it, and you kind of slid through it, was the issue of, well, if we do it in the United States, we don't really have to look globally. But I think our economy has changed, we are in a much more fluid, much more global economy than ever before, and I wonder what would be the implications if we make regulations, if we look and say, we will just make them smaller, or more controlled through taxing them, or requiring massive amounts of capital requirements, wouldn't that funding move overseas anyway, and therefore wouldn't that create the negative externalities that you were talking about before?

MR. KASHKARI: Well, I understand your concern. My view on this is we have to focus on what we can control. In an ideal world we would issue regulations and everybody around the world would share the same regulations, and there would be perfect harmony. But we have to focus on what we can control, and we can control the regulatory environment in the United States, and I think we should at least start there, let's make the changes that we need to make in the U.S., to make the U.S. financial system sound, let's have one set of rules, so if foreign global banks want to do business here, they ought to follow our rules if they want to do business here.

And by the way, I expect small and mid-sized banks in the U.S. to grow and fill some of the voids that may be created. Now, the other thing is, whatever we end up doing, if we go further, we do have to implement it gradually over time, and as we implement it gradually, I expect to see the banking sector and the economy evolve and adjust to fill whatever gaps may be created.

MR. WESSEL: Mark?

MR. SPINDEL: Thanks. A question for Neel. I'm Mark Spindel. You and the Chairman talked about the possible interaction and interference of monetary policy and macro-prudential management. I'm just hoping you can discuss your views about ways in which the most recent innovation, negative interest rates, helps or hinders your ability to regulate financial institutions.

MR. KASHKARI: Well, you know, I think that there are -- I refer back to Chair Yellen's testimony last week that, just on negative interest rates, it's something that I think the Board of Governors in the FOMC feels that they have the authority to use if necessary. But our current outlook is not that we would have to use them, our current outlook is for moderate economic growth, and are gradually increasing interest rates with inflation going back up over the medium-term to our target, and I'll probably leave it at that (crosstalk) --

MR. KOHN: And I don't think it necessarily affects the ability to regulate, so interestingly the Federal Reserve Board is stressing the banks against negative Treasury bill rates anyhow, right?

MR. WESSEL: Do you mean they are asking them --

MR. KOHN: Asking them. In the most recent stress test, the one that I guess they'll be doing this year, they are asking the banks to tell them how their capital would be affected if the interest rates went into negative territory.

MR. SPINDEL: Sure. But I mean, part of the selloff that we've seen from -- (inaudible) -- hence their ability to operate as lenders, and I'm just curious (inaudible) from a regulatory perspective, how the spenders --

MR. KASHKARI: Well, I guess I would say, I think these are things that are looked at very carefully, and those are factors that will be considered as the Committee moves forward.

MR. WESSEL: Bruce?

SPEAKER: Yeah. Neel, you used the term, for transformational change, because of the risk that you believe remains, then you list, first in that list, breaking up the big banks, and then you go on to list some others as potential transformational change. As soon as you -- my thought is, that as soon as you mentioned breaking up the big banks, nobody hears anything else, and writes off the whole idea. And that, therefore, some of the other ideas that have been mentioned, that you mentioned, and that have been mentioned by your co-panelists, like corporate governance change, and your mention of taxing higher leverage, higher, et cetera, et cetera, regulatory consolidation. These are transformational in their own ways, and they do not conjure up the ghost of trust busting.

MR. KASHKARI: I appreciate your comment, and I think there's a lot of wisdom in what you said. And that's why I want to emphasize that we are not announcing a solution, we are announcing a process to bring together experts, there are a lot of bold transformational ideas that are already out there from experts across the country. In my view we haven't given them yet the consideration that they deserve, and what I'm trying to do is bring us together to create a process to give those different options serious consideration and then we can, hopefully, together figure out what the best combination may be.

MR. WESSEL: Okay. The patient man in the orange shirt --

MR. MEYERCORD: Ken Meyercord, Worldox. I wonder if the panel agrees that capitalism is dependent on economic growth for its suitability as the basis for an economic system and therefore if we are in for a long period of economic stagnation with the cost of capital at zero, or even entering into negative territory, might not capitalism be replaced by some system that isn't dependent on usury?

MR. WESSEL: Okay. And the gentleman in front of you?

SPEAKER: Most of the quantitative in the models which are used, you know, by central banks in order guide them in macro stability decisions. Assume two things; one is the risk the premia are time-varying and that the second one is that the risk is endogenous. As a result, monetary policy, you know, can mitigate those risks. The question is, in the assumption that the risks are actually exogenous, does monetary policy have a role, and if not, what is the alternative?

MR. WESSEL: Alright. So, tell me again, what risks are you talking about?

SPEAKER: The risk premium which is, you know, time-varying.

MR. WESSEL: The risk premium.

SPEAKER: And then the risk which is assumed to be endogenous, so in other words, it's created by the bank's own activities, but in the event that risk is actually exogenous, it comes from other parts of the economy, does monetary policy have a role in mitigating those risks?

MR. WESSEL: Okay. Is it true then, when you think about monetary policy and models, you think of the risk premiums being endogenous, rather than exogenous?

MR. KOHN: Both. So I think, certainly the risk premium depends on the risk appetite, and that might be exogenous or affected by things outside of monetary policy, like global, political, geopolitical risks. At the same time I think the monetary authorities recognize that what they do, and how they are perceived to be operating and what the future brings, and whether they can convince people it's a good future, better future, does have an endogenous effect on risk premiums. So I'm not sure what --

MR. WESSEL: Neel, do you think what we are talking about here is the end of capitalism? That the banking system has gotten to the point where we can't accept market economy with banks that are privately owned?

MR. KASHKARI: Not at all. I mean, clearly the market economy is still going to be the key to our future, the key to economic growth, increasing prosperity, we just need to have a market economy where we can have that prosperity, that innovation, and we take off some of the risks, of collapse off of the table.

MR. WESSEL: Okay, Twitter?

SPEAKER: Thank you. Pretty briefly, why now, and why you, in terms of your sort of leaning on this issue?"

MR. KASHKARI: Sure. Well, why now, and why me? I just started at the Minneapolis Fed, so I'm moving as fast as I can, so that -- And why me? I feel like what I bring to this is a unique perspective like Don, like Chairman Bernanke, as being one of the few people who was on the frontline responding to the financial crisis. And that really colors my thinking ad my views as I look at the various reforms that have been implemented. And add to that, the Minneapolis Fed does have a lot of expertise in large banks and moral hazard, and I think bringing these things together to say, hey, I think we can do more, let's go do more.

And the last thing I'll say, I'm repeating myself, is that there are a lot of experts around the country who have strong ideas about this. We don’t presuppose that we have all the answers. We are trying to create a process to bring those experts together, and to let's, together, find a better solution.

MR. WESSEL: Martin?

SPEAKER: So, welcome back to Brookings. It's great to see you. I was a little concerned that you are not more enthusiastic about the single point of entry approach, and that way of dealing with large institutions. It seems like if you have enough TLAC, enough total loss-absorbing capacity, so that it would be very hard for any bank to run through it, you are going to basically say that taxpayers, are not going to support big banks. Using a single point of entry, you are able to resolve them, either through Title I, or through Title II, in a way that does not disrupt the system, and by creating a bridge bank you can allow foreign subsidiaries to operate. So why haven't we solved the problem? I mean, why are you wanting to do things that might gum up the gears more? Why not recognize this innovation for what it's?

MR. KASHKARI: Well, my concern is that if it really is -- let's just take the TLAC -- If it really is that credible, and it's really not going to trigger contagion, then it will be probably priced like equity. So why are we goofing around? Why don't we just raise the equity requirements of the banks, instead of adding all this complexity, and all this interaction? I mean there's tremendous complexity in all the regulations --

SPEAKER: It's the loss of equity, it's not (inaudible).

MR. KASHKARI: No. But I'll give you an example. If I'm remembering correctly, I'm going to stretch my mind here. Think about Fannie and Freddie in '08, first of all Fannie and Freddie were technically never supposed the responsibility of the U.S. Government. Yeah, we had to step in, and put the taxpayers behind Fannie and Freddie. Fannie and Freddie -- hang on --

SPEAKER: That would be the absolute based (inaudible).

MR. KASHKARI: Fannie and Freddie also had subordinated debt, that was there available to recapitalize the firms, and we ended up protecting the subordinated debt, right? So in theory that subordinated debt was TLAC, it was there specifically to provide protection for the senior creditors, and yet they ended up being protected in the midst of a crisis.

MR. WESSEL: Wait a minute. This is two different points here, one is -- and I think they are different -- One is, you are saying that basically we can't take the government at its word. That in a crisis, they will never allow the bondholders to take the hit that they've been warned against; right?

MR. KASHKARI: That's probably saying it a little stronger than I would say it, but yes.

MR. WESSEL: Okay. That's a separate question from, and what's the answer, why has the banks issued bonds, that could become capital, what's the advantage of that, over just having them hold more equities? Is it cheaper, or?

MR. KOHN: Yes. I think it's diversified, it's a little, it appeals to different investors, it's probably a little less expensive than equities, it's something that will pay interest until it converts to equity. I think these are new types of instruments, particularly those convertible bonds that we were talking about earlier. In the U.S. they are not issuing those, they are issuing -- I guess, they are issuing more equity but more preferred shares. And other subordinated debt at the holding company thing. So, yeah, I do think it's not -- you know, they are different investors, different characteristics. I assume they will be a different cost and --

MR. KASHKARI: But again, I know I mentioned this earlier, but go back to the SIVs, there was no legal requirement for the banks to bail out the SIVs.

MR. KOHN: I don't see them -- I don't see the analogy here so --

MR. KASHKARI: There was a reputational requirement, and so in the midst of a crisis, all of a sudden, if you were to analyze the balance sheets of these banks, they looked healthy until all of a sudden, the management said, oh, my, gosh, we have a reputational requirement to stand behind --

MR. WESSEL: Do you think the banks will have a concern about their reputation if they convert the bonds?

MR. KASHKARI: I guess what I'm -- Well, there's that, but I'm just saying the lesson for me from that, is that these very clear, legal frameworks that look very clear today, are not so clear in the time of a crisis.

MR. WESSEL: Gary?

MR. STERN: Are you going to go to -- This maybe where I -- Are you going to go to prompt mark-to-market economy? Because it seems to me that's critical, that's critical here. Otherwise, you know, the regulators can -- the loose get -- the recognition of the losses get delayed and until you find out indeed, there is, it is swamping capital. Now, I know a lot of people in financial services, as soon as you say, mark-to-market economy, you know, that's like there's a rat running around the room here. But, you know, it takes a model to beat a model. So if you like that, what's better?

MR. KOHN: I think the regulators have been pushing, certainly pushing the accountants to allow the banks to recognize losses in a more forward-looking way than they have in the past. I think the mark-to-market accounting is very useful, but it's a little tricky on the liability side of the balance sheet, and can give us a win when these bonds sell off, the banks have more equity, not really, so it's a tricky issue.

SPEAKER: Yes.

MR. KOHN: But I think recognizing the value of the assets, and the impairments of the loans, is absolutely critical for the health of the system and the market discipline, right.

MR. WESSEL: Let's take a couple; there's one here, and that gentleman in the front; and then we'll call it a day.

MS. LINER: Thank you, I'm Emily Liner. I'm a Policy Advisor with ThirdWay, and I wanted to go back to Mr. Kashkari's announcement of the Minneapolis Fed Initiative for ending too big to fail. You acknowledged that it will eventually require congressional actions, did you do anything to end too big to fail, and that's probably the biggest obstacle, given that a lot of members of Congress don't agree with your initial premise that Dodd-Frank didn't go far enough. So, how would your initiative address this impasse in a way that we haven't been able to in the last six years?

MR. WESSEL: Okay. And the gentleman, here?

MR. FARR: Thank you so much. I'm Steve Farr, from the Woodrow Wilson Center. We are facing very feeble global economy right now, so I was wondering if you guys think it's possible that the next global financial crisis, or global downturn will be triggered not from here, but from any other foreign market. Thank you very much.

MR. WESSEL: Okay. Two good questions. So, Neel, are you going to fix Congress, too, while you are at it? (Laughter)

MR. KASHKARI: That's it? Look, we have to do what we can, and we have responsibility to educate the public, that's why we are -- By the way, we can go disappear into a close, and come out in nine months, and come up with our answer. The reason we are having a public process with live streaming the symposium, is bringing the experts in, and having the press there, is to also educate the public along with us, and hopefully we can get Members of Congress on both sides of the aisle, to pay attention and to participate and take this seriously. So I take your point, we have to do whatever we can to try to get there.

MR. WESSEL: Anybody wanted to -- What are the odds that the next global financial crisis has its origins, not in Northern California, but somewhere else, outside the United States?

MR. KOHN: I think they are pretty high, but I also think, and certainly a lot of the weakness that people are worried about today, is less I the U.S., and more overseas. But I also think it's important to note, that there's a lot of international cooperation to strengthen banking systems everywhere through the Financial Stability Board, and to agree on resolution regimes; to agree on higher capital through Basel, and the FSB, to agree on a framework that will make the system much safer and more resilient to shocks wherever they come from.

Everybody is very, very aware that they could come from anywhere, and Neel's point is perfectly -- is absolutely true. Whatever trigger something bad coming down, we probably don't see it, and won't see it, until it's right on top of us.

MR. KASHKARI: Earlier somebody mention, by the way, oil prices. Should we have seen that? I mean, again, it's not the same thing as the housing bubble, I don't know of anybody who said, oh, there's an oil bubble and we need to take action to protect various sectors of the economy, and so things happen. There are exogenous shocks, and we need to humble about how well we can predict them.

MR. STERN: I don't think we'll identify the source of the next crisis before it happens. I think that's highly unlikely. I think the best thing we can do is try to be as prepared for it, for whatever its source, as possible, and which to me means getting the incentive -- straightening out the incentives in the financial services industry first and foremost.

MR. WESSEL: Do you think we are better off than we were the day before this all started in 2007?

MR. STERN: Yes. I think we are clearly better off. We are maybe on second or third base. But we know where home plate it is, or at least I think I know where home plate is, I won't speak for others. We've got to get there.

MR. WESSEL: Okay. With that, please join me in thanking our panelists. (Applause)

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