Remarks by Vikram Pandit at the London School of Economics
"A Global Financial System for the Next Generation"
March 5, 2009

As prepared for delivery

Thank you very much, Howard (Davies).

I am delighted to be here today. I want to thank Sir Howard and the LSE for this great institution's long standing relationship with Citi. It is a special partnership. As you may know, many LSE graduates have been outstanding contributors to some of Citi's great accomplishments through the years.

When I was in The City just nine months ago, speaking to the British Bankers Association, I called for a serious re-think on the architecture of the global financial system. I said what we had then was poorly suited for these modern times. Looking back now on the staggering series of events that followed, starting with the collapse of Lehman Brothers in September and continuing through today, we have seen major recapitalizations of some of the largest banks throughout the world … and a deepening recession in the major global economies.

When a financial crisis spills out and impacts the lives of people around the world the way this crisis has, it's clear that we need to dramatically rethink our global financial architecture.

In reality, we have never had a genuinely global architecture. Instead, we have been riding on a high-speed train … but on rails laid more than sixty years ago for a simpler, slower-paced world. Government regulatory mechanisms and private sector managers had capacity limitations that could not handle the rapidly accelerating pace and volume of new financial products being pushed through the system. Our high-speed train eventually exceeded the system's capacity to control it.

To lead Citi in these exceptional times has been a humbling and sobering experience. Many colleagues in global financial centers around the world have lost their jobs and historic institutions have shut their doors. The very bedrock of the principles of capitalism has been shaken. And the world is watching – literally – what we in the banking community are doing on a daily basis. As I told members of the U.S. Congress three weeks ago, "I get the new reality" and "I will ensure that Citi gets it as well."

Since I became CEO at Citi in 2007, we have been taking steps to achieve a rapid return to profitability and to be a part of the solution to the problems we in the financial community now face together.

We are not only restructuring our company and reworking our own internal systems of risk management, but we must also collaborate with governments … in ways never anticipated … because we are a major systemic financial institution.

I'll say more about Citi later but I want to state clearly here that we – as Citi – recognize that we must be a leader in helping to shape the new global financial architecture. We are keenly aware that hundreds of millions of people are expecting us to deliver.

Many exceptional people – scholars, government officials and private sector experts – are contributing to the multilateral discussion about a new global financial framework. Thankfully, a renewed political will, articulated through the G20 heads of state, has moved decisively beyond what had been a tactical and technical discussion to one that is considerably more transparent and inclusive. The net result will be a global system that is far better understood … as well as much better regulated and appreciated.

That said, we clearly are in the early stages of an exercise that still can fall short of an effective solution.

This leads me to a crucial point, especially for all of us here today: the reshaping of global financial markets in the next few years will have an extraordinary impact on the potential for raising living standards, … improving quality of life, and confronting climate change and other urgent global issues over the next 50 years. We cannot underestimate the scale of the impact. This is a paradigm shift that will determine how well this global re-setting is managed. It will be one of the defining historical events of this generation … of your generation.

I believe, along with many others directly involved, three issues are critical for the creation of this 21st century global regulatory system:

- First, a regulatory structure that will allow markets to clear efficiently;
- Second, a financial architecture that can truly optimize global GDP growth;
- Third, global coordination.

Regulatory Structure

The regulatory debate is complex, but it is clear that it should not be about a rebalancing between government and free markets. This debate needs to be about how we design regulation and market architecture that allows free markets to flourish, while still being systemically responsible. It's a question of, how tightly do you hold the canary?

Let me be clear: We need regulation to make markets work better. The place to start is by regulating transparency. Transparent markets generally work and partial regulation is not a second best answer.

Of course, the pushback to this view is the risk of self-interest in free markets. Self-interest among market participants is not only unavoidable, but is the driver of creativity, innovation and wealth creation. But self-interest needs checks and balances. Markets can do that by being arbiters and by clearing trades. But that can only happen if there is transparency.

Many fundamental parts of our financial markets remain opaque; they have been shielded in different ways from the information revolution. In addition, individuals have no incentive to seek transparency.

Market participants need access to trading information, volumes, open interest, and financial information that is easily understood. At the international level, we need to ensure that the institutions created to manage the process have the tools … and the mandate … to maintain the transparency needed for efficient market behavior.

Second, we need a **level playing field**—a system for uniform, consistent measurement.

Clearly, one of the biggest challenges for developing a unified international regulatory regime is measurement. Good accounting policies and consistent capital requirements are critical to measurement, among other things. Good accounting policy … *globally* considered and *globally* applied … is essential for stable markets that encourage investment, innovation and growth. Right now, we don't have that. We don't even have consistent capital requirements globally, which creates an unlevel playing field and leads to behavior that increases systemic risks.

When we do not have level playing fields, self-interest becomes unavoidable … and, as we have seen in the financial markets, self-interest can increase systemic risks.

Our accounting systems can work better. There is a significant divergence between economics and accounting. Accounting rules don't necessarily capture economic value. Nowhere is this clearer than in the measurement of capital supporting businesses.

As economists and well-trained and savvy mathematicians, you all know that capital in any organization can be measured by using contingent claims analysis. Contingent claims analysis looks at current and future cash flow and net realizable values … both on the asset and liability side … understands the duration and variability of both assets and liabilities … and brings this back to the

present: … the value of the enterprise. This approach recognizes that the value of an asset is not independent of the liability funding it.

Confusion arises when we treat assets and liabilities separately or just think about the value of assets, and ignore liabilities completely.

The two formats for financial institutions where current policies work best are:

- In trading firms that carry liquid and tradable assets funded in wholesale liquid and tradable liabilities, where it's clear that mark to market accounting can apply; and
- In pure banks, where it makes sense to have total accrual accounting because long-term assets are funded with stable deposit funding, and, therefore, what matters is realized and expected losses, not liquidity. So, this is also an asset/liability matched application.

But mark-to-market accounting principles do not recognize that the value of an asset is not independent of its funding source.

Basically, accounting stops working when we have deposits funding tradable assets—and only one side of the balance sheet is marked to market. Or, when we have wholesale funds funding accrual assets.

Billions of dollars of capital in the banking system have been impacted by various accounting rules, including this asset/liability mismatch. The debate is not whether to mark to market or not, it's about applying contingent claim analysis to truly understand the capitalization of banks.

Third, we need overarching systemic regulators. Regardless of what we do, not every market will be transparent. Not every financial product or risk can be quantified in a way that allows the markets to clear. This is when regulators need to step in and aggregate information to make sure that actions and self-interest still manage to drive a consistent result for the economy.

We have also seen in times of stress, just about any meaningful financial institution is systemically important. We must therefore cast a very wide net around many financial institutions and activities.

I want to hear your point of view on these three issues – transparency, creating the level playing field and the need for systemic regulators. I know Sir Howard has written extensively on regulatory architecture, especially on what is needed in the EU in terms of systemic surveillance. I also want to hear your thoughts on what you consider the right architecture for optimal global GDP growth, so let me turn to that now.

Architecture for Optimal Global GDP Growth

Historically, bank lending funded credit creation. But, over the past 20 years or so, finance companies and securitization markets surpassed banks in providing most of the growth in credit, particularly to fund SMEs, entrepreneurs and innovative industries … but often beyond the reach of the banking regulators.

As we think about designing the new architecture, we need to ask: how much global GDP growth should we have? How much credit creation does that level of global GDP growth require? Is the funding available for that desired level of credit creation? When you do the analysis, it is clear that there may not be enough bank deposits in the world to support the credit requirements for optimal economic growth. To create the opportunity for this growth, alternate credit creation vehicles such as the securitization markets are going to remain crucial.

Global regulators are taking aggressive steps to unfreeze these types of markets. In the United States, the Treasury and Federal Reserve recently announced a program to unfreeze the securitization markets, the Term Asset-Backed Securities Loan Facility. This potentially will provide $1 trillion to increase credit availability to consumers in the U.S. But many of the programs created recently may be temporary solutions. We need to think about permanent long-term solutions. Such solutions may require a helping hand.

The current crisis frames the new stress test that all financial firms will apply to their business models and risk-taking activities. And they will find that the equity requirements to sustain securitization and credit creation at reasonable prices may be prohibitively highly. We in the U.S. are going to have to create an architecture that will deliver the level of credit creation we desire.

During the American Depression, the U.S. Government established Federal Deposit Insurance … a recognition that funding is crucial to lending. This was important in an era when deposits funded credit creation. In today's market, wholesale funding also drives credit creation through vehicles like securitization. One key question we now need to address for the global regulatory architecture is: What is the equivalent global deposit insurance we need to ensure that all credit creation markets function as they should?

We relied on rating agencies in the current cycle to arbitrate the market. Looking forward, rating agencies are not going to be able to serve the same function. We need to think about different mechanisms. Let me give you one suggestion: an insurance structure. Any insurance-based program is likely to provide more checks and balances to deal with complex markets, much more so than any ratings agency can. We may need a long-term insurance structure around money markets … or around mortgages, as they have in Canada.

The goal is to design a system that will allow markets to clear and that will allow GDP to grow at the optimal rate. We can agree that there aren't enough deposits in the world to fund optimal global GDP growth … A safety net for the wholesale funding markets developed in a globally coordinated way may be the answer. To achieve this objective, global coordination is essential.

Global Coordination

Of course we need to recognize that globalization is a powerful force of nature. Free trade and international capital flows still offer the same promise of expanding global wealth and improving social welfare, as they always have. I firmly believe this.

It couldn't be clearer to me that the financial crisis was ***not*** caused solely by complexity of products or globalization. The crisis also happened because we did not build the rails to cope with the new high-speed trains.

The basic principles of global coordination are:

- uniformity of approaches to market structure
- strong linkages between central banks throughout the world
- well-capitalized clearing houses throughout the world
- consistent rules for capital, accounting, foreign exchange, etc., that promote global capital flows without hindrance.

Citi's Core Mission

I mentioned earlier that we at Citi intend to be leaders in creating the new global regulatory framework. Despite the disappointments and turmoil we've experienced for more than a year … I believe we have an important role to play in the restoration of global economic growth.

Our core mission is to enable capital to flow around the world and to stimulate economic growth. In these times, cross-border capital flows from savings-rich economies to savings-short economies are going to be essential to restart global economic growth. There is no question about that. No financial institution in the world is as well positioned to provide these services as Citi. We operate in 109 nations, with more than eight of every 10 employees working in their home countries. Citi is a unique franchise, with an operating model that allows us to be both very local, and very global. [Many others talk about this. We actually do it.]

One of the most immediate challenges in the global economy is to keep global markets open and accessible for trade and investment during this period. For 30 OECD member countries alone, total exports in 2007 amounted to 11 trillion U.S. dollars, and imports reached 11.5 trillion U.S. dollars.

Summary of Key Points

Before concluding, let me quickly reiterate my three key points:

First, in order to create an effective, truly global regulatory system for 21st century financial markets, we need a regulatory structure with: (1) **greater transparency** that will allow markets to function as efficiently as possible on their own; and (2) **a level playing field based on a system of uniform and consistent measurement** that is globally applied to support stable markets that encourage investment, innovation and growth; and (3) an overarching systemic regulatory supervisor to ensure better oversight and management of global risks.

Next, we need to identify and apply the requirements for a global financial architecture that will help drive global GDP growth. The goal is to design a system that will allow markets to clear and to establish a safety net for the wholesale funding markets required to help drive global GDP growth.

Finally, all of this requires global coordination. I agree with many conclusions by the G20 and by leading scholars, government officials and private sector experts elsewhere who call for enhancing the strengths of existing international institutions such as the IMF, the Financial Stability Forum, the World Bank and others.

The discussions we're all reading about on global coordination are considerably more transparent and inclusive than in the past. This is very encouraging, and can result in a global system that is far better understood … and much better regulated and appreciated.

Conclusion

I said at the beginning that we are still in the early stages of a creating a global regulatory system, an effort that could still fall short of an effective solution. But I am optimistic. We have a better understanding now of the causes of the current extreme dislocation and disruption. And understanding the causes will enable us to move more quickly towards a rebuilt system.

Each of us remembers history in the context of our generation and our education. Many aspects of what we're going through … the first global recession in 60 years … are not that unusual. What we learn, time after time … is that the answers to crises of this magnitude have a common thread. The answers are discovered and implemented through the collective genius of dedicated intellectual capital.

So I want to extend an invitation. In the global financial industry … and certainly at Citi … we are searching for the best and brightest of your generation. We are eager for you to participate in this historic process to reform and revitalize the global financial markets. Reform that will determine our ability to manage major global challenges, such as climate change, and the quality of life for billions of people for years to come. How well or how poorly the global financial markets are reshaped is in ***both*** of our generations' hands.

Thank you very much.

End