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How to prevent America's next financial crisis

By Timothy Geithner
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America is close to turning the page on this economic crisis. While far too many Americans are still out of work and face deep economic hardship, we have now reported three quarters of positive growth and the beginnings of job creation. As the economy improves, we are winding down the Troubled Assets Relief Program, and Congress is moving toward enacting the strongest financial reforms since those that followed the Great Depression.

In fact, we are repairing our financial system at much lower cost than anyone anticipated and expect to return hundreds of billions of dollars in available but unused TARP resources to the American people. That is a rare achievement in Washington.

Our latest estimate conservatively puts the cost of TARP at $117 billion, and if Congress adopts the Financial Crisis Responsibility Fee that the president proposed in January, the cost to American taxpayers will be zero. More broadly, we estimate the overall cost of this crisis will be a fraction of what was originally feared and much less than what was required to resolve the savings-and-loan crisis of the 1980s.

The true cost of this crisis, however, will always be measured by the millions of lost jobs, the trillions in lost savings and the thousands of failed businesses. No future generation should have to pay such a price.

It is simply unacceptable to walk away from this recession without fixing the system's basic flaws that helped to create it.

Thankfully, signs of bipartisan support for action seem to be emerging in Washington, including for an independent consumer financial protection agency.

That is welcome news. The best way to protect American families who take out a mortgage or a car loan or who save to put their kids through college is through an independent, accountable agency that can set and enforce clear rules of the road across the financial marketplace.

But consumer and investor protection, while critical to reform, are only one part. As the Senate bill moves to the floor, we must all fight loopholes that would weaken it and push to make sure the government has real authority to help end the problem of "too big to fail."

To prevent large financial firms from ever posing a threat to the economy, the Senate bill gives the government authority to impose stronger requirements on capital and liquidity. It limits banks from owning, investing, or sponsoring hedge funds, private equity funds or proprietary trading operations for their own profit unrelated to serving their customers. And it prevents excess concentration of liabilities in our financial system.

All of that means major global financial institutions -- whether they look like Goldman Sachs, Citigroup or AIG -- will be required to operate with less leverage and less risk-taking.

Crucially, if a major firm does mismanage itself into failure, the Senate bill gives the government the authority to wind down the firm with no exposure to the taxpayer. No more bailouts. Instead, we will have a bankruptcy-like regime where equityholders will be wiped out and the assets will be sold.

These are important steps, but they are not enough. Ending "too big to fail" also requires building stronger shock absorbers throughout the system so it can better withstand the next financial storm. To do that, the Senate bill closes loopholes and opportunities for arbitrage, and it brings key markets, such as those for derivatives, out of the shadows.

Transparency will lower costs for users of derivatives, such as industrial or agriculture companies, allowing them to more effectively manage their risk. It will enable regulators to more effectively monitor risks of all significant derivatives players and financial institutions, and prevent fraud, manipulation and abuse. And by bringing standardized derivatives into central clearing houses and trading facilities, the Senate bill would reduce the risk that the derivatives market will again threaten the entire financial system.

A clear lesson of this crisis is that any strategy that relies on market discipline to compensate for weak regulation and then leaves it to the government to clean up the mess is a strategy for disaster.

This is a defining moment for financial reform. We have to get it right. We cannot build a system that depends on the wisdom and judgment of future regulators. Even the smartest individuals armed with the sharpest tools will not be able to find every weakness and preempt every crisis. Instead, the best strategy for stability is to force the financial system to operate with clear rules that set unambiguous limits on leverage and risk.

We need that to happen here and around the world. Importantly, with the Senate bill, the United States would have a strong hand in negotiating a global agreement on new capital requirements by the end of the year. Such an agreement would establish a level playing field with minimum requirements for capital, and compliance would be open to scrutiny by regulators and the markets.

The Senate bill is strong. It would create an independent agency to better protect American families across the financial marketplace. It would protect against "too big to fail." And it would bring the derivatives market out of the dark. As the bill moves to the floor, we will fight any attempt to weaken it. The American people have suffered through too much to enact reform that does too little.

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