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Good morning. I appreciate the opportunity to speak with you today. For more than two decades, the Council of Institutional Investors has committed itself to the values of accountability, transparency and responsible ownership. I'm pleased to be able to speak to those principles in front of a group that has played such a powerful role in advancing them over the years.

To begin with an obvious point, much of the past year has been deeply humbling for my industry. We held ourselves up as the experts, and the loss of public confidence from failing to live up to the expectations that we created will take years to rebuild. Worse, decisions on compensation and other actions taken and not taken, particularly at banks that rapidly lost a lot of shareholder value, look self-serving and greedy in hindsight.

Financial institutions have an obligation to the broader financial system. We depend on a healthy, well-functioning system, but we collectively neglected to raise enough questions about whether some of the trends and practices that became commonplace really served the public's long-term interests.

Meaningful change and effective reform are vital and should naturally emanate from the lessons learned. I will discuss a few of the more important lessons from this crisis. I'd also like to highlight some of the regulatory guideposts that may help us to improve the broader systemic management of risk, increase the level of institutional accountability and enhance investor confidence.

Without trying to shed one bit of our industry's accountability, we would also further our collective interests by recognizing other contributing causes to the severity of the cycle we are living through.

As a matter of policy, we allowed housing prices to be subsidized, including through implied government support of Fannie Mae and Freddie Mac. We watched as high consumption and low savings rates as well as entitlement spending were increasingly encouraged and financed through the twin deficits.

Factors from both Main Street and Wall Street contributed to today's circumstances. Neither part of our economy acted completely independent of the other. So, any examination of how we got to this point must begin with an understanding of some of the global economic and financial dynamics of the last two decades.

Certainly, what started in a localized part of the U.S. mortgage market spread to virtually every corner of the global financial markets. But the genesis of the problem wasn't in sub-prime. Instead, the roots of the damage to our financial system are broad and deep. They coalesced over many years to create a sustained period of cheap credit and excess liquidity. The resulting under-pricing of risk led to massive leverage across wide swaths of the economy – from households to the corporate sector to the public sector.

I see at least three broad underlying factors:

- First, there has been enormous growth in the amount of foreign capital, much of it held in large pools, and a very significant shift in the balance of payments of many emerging markets;
- Second, and linked to this, nearly ten years of low long-term interest rates; and
- Third, the official policy of subsidizing homeownership in the United States.

Let's take each in turn, beginning with the growth in foreign capital.

Between 1992-2007, the U.S. current account deficit increased by more than 1,300 percent. During the same period, China's current account surplus increased by over 5,700 percent, as did the surplus for the oil exporting nations.

After previous financial crises, emerging economies began to self-insure against a repeat of those events by building up their foreign currency reserves. Their primary objective was to reduce their dependence on dollar-denominated domestic debt.

Of course, the other, perhaps more significant factor in the growth in current account surpluses had been the record run-up in oil prices since 2000. Increases in global savings run almost parallel with the increase in petrodollar flows.

The growth in foreign capital had a profound effect on the global economy. Foreign holdings of U.S. government and corporate debt skyrocketed. China's monthly average purchases of U.S. long-term securities went from less than $2 billion in 2001 to over $15 billion in 2007.

The flood of foreign capital into safe and liquid assets, particularly U.S. Treasuries, helped push relatively low long-term interest rates down even further. And they stayed low, even after the Federal Reserve began raising short-term rates in 2004.

This was accompanied by a significant reduction in inflation. Between the period 1985 and 1995 versus the next 12 years, inflation in advanced economies fell by more than one-half.

Enormous excess liquidity, strong global economic growth and low real-interest rates created a desire to find new investment opportunities. Many of the best were thought to be in the housing market. The reasons are three-fold.

First, governments, particularly the U.S., explicitly supported homeownership through a variety of government programs and initiatives. Second, mortgage assets were considered relatively impervious to sharp downturns. And lastly, the creation of more flexible and varied mortgage products attracted even more capital in search of higher returns.

These factors, to varying degrees, contributed to a housing bubble – not just in the U.S. but in many other countries as well. While real home prices increased nearly 50 percent in the U.S. between 1998 and 2006, they increased more than 130 percent in Ireland, 120 percent in the U.K. and Spain and over 100 percent in France.

Not surprisingly, in the U.S., mortgage origination as a percentage of total mortgage debt outstanding rose from an average of 6.3 percent between 1985 and 2000 to 10 percent between 2001 and 2006. Sub-prime debt, in particular, grew from just over 2 percent in 2002 to 14 percent in 2008. In a sustained environment of cheap capital, lending standards for residential mortgages simply deteriorated.

As I have thought about our industry's understanding of the previous years' risks, it is important to reflect on some of the lessons.

At the top of my list are the rationalizations that were made to justify that the downward pricing of risk was different. While we recognized that credit standards were historically lax, we rationalized the reasons with arguments such as: the emerging markets were more powerful, the risk mitigants were better, there was more than enough liquidity in the system.

We rationalized because our self-interest in preserving and growing our market share, as competitors, sometimes blinds us – especially when exuberance is at its peak.

A systemic lack of skepticism was equally true with respect to credit ratings. Too many financial institutions and investors simply outsourced their risk management. Rather than undertake their own analysis, they relied on the rating agencies to do the essential work of risk analysis for them. This was true at the inception and over the period of the investment, during which time they did not heed other indicators of financial deterioration.

This over-dependence on credit ratings coincided with the dilution of the coveted triple A rating. In January 2008, there were 12 triple A-rated companies in the world. At the same time, there were 64,000 structured finance instruments, like CDO tranches, rated triple A. It is easy to blame the rating agencies for their credit judgments. But the blame is not theirs alone. Every financial institution that participated in the process has to accept part of the responsibility.

More generally, risk management will come to define the events of 2007 and 2008. First, models, particularly those predicated on historical data, were too often allowed to substitute for judgment.

In the last several months, we have heard the phrase, "multiple standard deviation events" more than a few times. If events which were calculated to occur once in twenty years in fact occurred much more regularly, it doesn't take a mathematician to figure out that risk management assumptions did not reflect the distribution of actual outcomes. Our industry must do more to enhance and improve scenario analysis and stress testing.

Second, size matters. For example, whether you owned $5 billion or $50 billion of (supposedly) no-risk super-senior debt in a CDO, the likelihood of losses would appear to be the same. But the consequences of a miscalculation were obviously much bigger if you had a $50 billion exposure.

Third, a lot of risk models incorrectly assumed that positions could be fully hedged. After LTCM and the crisis in emerging markets in 1998, new products like basket indices and credit default swaps were created to help offset a number of risks. However, we didn't, as an industry, consider carefully enough the possibility that liquidity would dry up, making it difficult to apply effective hedges.

Fourth, risk models failed to capture the risk inherent in off-balance sheet activities, such as Structured Investment Vehicles (SIVs). It seems clear now that managers of companies with large off-balance sheet exposure didn't appreciate the full magnitude of the economic risks they were exposed to; equally worrying, their counterparties were unaware of the full extent of these vehicles and, therefore, could not accurately assess the risk of doing business. Post Enron, that is quite amazing.

Fifth, complexity got the better of us. The industry let the growth in new instruments outstrip the operational capacity to manage them. As a result, operational risk increased dramatically and this had a direct effect on the overall stability of the financial system.

Lastly, financial institutions didn't account for asset values accurately enough. I've heard some argue that fair value accounting – which assigns current values to financial assets and liabilities – is one of the major reasons for exacerbating the credit crisis. I see it differently. If more institutions had properly valued their positions and commitments at the outset, they would have been in a much better position to reduce their exposures.

For Goldman Sachs, the daily marking of positions to current market prices was a key contributor to our decision to reduce risk relatively early in markets and in positions that were deteriorating. This process can be difficult, and sometimes painful, but I believe it is a discipline that should define financial institutions. We mark-to-market, not because we are required to, but because we wouldn't know how to assess or manage risk if market prices were not reflected on our books.

While this is not an exhaustive list of what went wrong, our focus is on learning from these lessons and others that will undoubtedly emerge as we work our way through this period.

The Administration, legislators and regulators have begun to consider the important regulatory actions to be taken and our firm pledges to be a constructive participant in that process. In that vein, I believe it is useful, in light of the lessons we take away from this crisis, to consider important principles for our industry, for policymakers and for regulators.

For the industry, we can't let our ability to innovate exceed our capacity to manage. Given the size and interconnected character of markets, the growth in volumes, the global nature of trades and their cross-asset characteristics, managing operational risk will only become more important.

Risk and control functions need to be completely independent from the business units. And clarity as to whom risk and control managers report is crucial to maintaining that independence. Equally important, risk managers need to have at least equal stature with their counterparts in revenue producing divisions. If there is a question about a mark or a disagreement about a risk limit, the risk manager's view should prevail.

Understandably, compensation continues to generate a lot of controversy and anger. We recognize that having TARP money creates an important context for compensation. That is why, in part, our executive management team elected not to receive a bonus in 2008, even though the firm produced a substantial profit. Beyond TARP, public scrutiny, a renewal of common sense and, perhaps, regulation will naturally affect compensation practices going forward.

More generally, we should apply basic standards to how we compensate people in our industry. Compensation should reflect an individual's ability to identify and create value, including his or her contribution to the client franchise, enhancing the firm's reputation and contributing to the better functioning and efficiency of markets.

Equally important, compensation should take into account strict adherence to a firm's management and controls, especially with respect to a person's judgment and exercising that judgment in terms of risk in all of its forms. That evaluation must be made on a multi-year basis to get a fuller picture of the effect of an individual's decisions.

And, individual performance must not be viewed in isolation. Individual compensation should not be set without taking into strong consideration the performance of the business unit and the overall firm. Employees should share in the upside when overall performance is strong and they should all share in the downside when overall performance is weak.

No one should get compensated with reference to only his or her own P&L. Compensation should encourage real teamwork and discourage selfish behavior, including excessive risk taking, which hurts the longer term interests of the firm and its shareholders.

We also believe it is important to set forth specific guidelines on how we compensate in our industry.

- Compensation should include an annual salary plus deferred compensation, which is appropriately discretionary because it is based on performance over the entire year.

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

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

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

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

At Goldman Sachs we believe attracting and retaining the best people is vital to our effectiveness and that incentives are an important element in that process. But we also recognize that, misapplied, they can also encourage excess. As an industry, we need to do a better job of understanding when incentives begin to work against the social good rather than for it and take action to redress the balance.

For policymakers and regulators, it should be clear that self-regulation has its limits. At the very least, fixing a system-wide problem, elevating standards or driving the industry to a collective response requires effective central regulation and the convening power of regulators.

While all of us in the industry have a common responsibility to ensure the system's operational integrity, it is not realistic to expect that one firm alone can fix a system-wide problem like unsigned trade confirmations or the establishment of a central clearing facility.

Capital, credit and underwriting standards should be subject to more "dynamic regulation." Regulators should consider the regulatory inputs and outputs needed to ensure a regime that is nimble and strong enough to identify and appropriately constrain market excesses, particularly in a sustained period of economic growth. Just as the Federal Reserve adjusts interest rates upward to curb economic frenzy, various benchmarks and ratios could be appropriately calibrated.

To increase overall transparency and help ensure that book value really means book value, regulators should require that all assets across financial institutions be similarly valued. Fair value accounting gives investors more clarity with respect to balance sheet risk. How can one justify that the same instruments or risks are priced differently because they reside in different parts of the balance sheet within the same institution?

As recognized at the recent G20 Summit, the level of global supervisory coordination and communication should reflect the global interconnectedness of markets. Regulators should implement more robust information sharing and harmonized disclosure, coupled with a more systemic, effective reporting regime for institutions and major market participants. Without these, regulators will lack essential tools to help them understand levels of systemic vulnerability in the banking sector and in financial markets more broadly.

In this vein, all pools of capital that depend on the smooth functioning of the financial system, and are large enough to be a burden on it in a crisis, should be subject to some degree of regulation. Yes, that includes large hedge funds and private equity funds.

After the financial shocks and unsettling developments of recent months, I understand the desire for wholesale reform of our regulatory regime. And, in many cases, it is warranted. But we also should resist a response that is solely designed to protect us against the 100-year storm.

As long as human emotions influence decisions, this won't be the last financial crisis the world has to contend with. But, most of the last century has been defined by markets that fund innovation, reward entrepreneurial risk taking and act as an important catalyst for economic growth.

History has proven that a vibrant, dynamic financial system is at the heart of a vibrant, dynamic economy. The U.S. brand of that system has produced growth nearly one-third higher than the rest of the industrialized world over the last two decades.

The events of the last year have put into stark relief the tension between innovation and stability. But, if we abandon, as opposed to regulate, market mechanisms created decades ago, like securitization and credit default swaps, we may end up constraining access to capital and the efficient hedging and distribution of risk, when we ultimately do come through this crisis.

Certain developments of recent decades, like changes in the structure of financial institutions post Glass-Steagall, have brought the risk of less frequent but more intense upheavals. The diverse income streams of mega financial conglomerates reduce the effects of the 10-year storm, but their size and ubiquity exacerbate the consequences of the 20- or 30-year storm.

Over the last several months, there have also been a number of broader policy lessons. Many had previously accepted the bifurcation of Wall Street and Main Street as well as the decoupling of the United States from the international economy. Both have proven false. In 2007, there were pitched debates over whether policy was being geared towards Wall Street at the expense of Main Street. Today, Wall Street remains destabilized, impeding the broader economy.

In terms of international implications, we have also seen actions that, for all intents and purposes, are protectionist and self-defeating. For instance, recent legislation constrains the ability of financial institutions to hire employees through the H-1B visa program. This program helps bring the most highly trained and technical people into our labor market.

The U.S. has always been a magnet for many of the most talented, hungry and qualified people in the world. Especially at this time in our economy, do we really want to tell individuals who will help companies to grow and innovate – ultimately creating more jobs – that they should go work elsewhere?

Equally significant and using Goldman Sachs as an example, we have approximately 200 employees who are in the U.S. because of the H-1B program. But, we have 2,000 employees who are working overseas and pay U.S. taxes. Do we want to invite other countries to take punitive measures against us?

This may be a relatively minor issue in the midst of the significant challenges we face, but I think it speaks to a potentially dangerous trend of withdrawing at a time we should do the opposite. While I don't dismiss political considerations, short-term salves like the "Buy America" provision or mandating a certain level of domestic lending will only end up harming the process underlying economic growth.

All along, we have known that market events and economic trends are interwoven on a global basis. But the events of the last year have shown that the connections are more direct and immediate than perhaps we previously appreciated.

In times of economic distress, the relationships between creditor and debtor countries take on even more complex dynamics…especially as we are the largest debtor. We have learned that when a major financial institution fails in a debtor country, a creditor country is likely to pull back from its financing relationship in one way or another and, maybe, in every way.

For the United States at this time, the relationship is not just a matter of here and abroad; it is also a relationship between a debtor and its creditors. Certain of our economic decisions that have implications for our international partners could reverberate back to us very quickly and with great consequences in the current environment.

I want to conclude today with the following thought: we are fighting for nothing less than the immediate health and security of every person. We can never forget the products of economic growth – more accessible health care, better education, less crime, tolerance of diversity, social mobility and a commitment to democracy.

In so many respects, change is the order of the day. We have much to do to repair our financial system and reinvigorate our regulatory structure. At the same time, our financial system, rooted in the belief of putting risk capital to work on behalf of ideas and innovation, has helped produce a long-term record of economic growth and stability that is unparalleled in history.

We have to safeguard the value of risk capital, which is at the heart of market capitalism, while enhancing investor confidence through meaningful transparency, effective oversight and strong governance. But, there should be no doubt: markets simply cannot thrive without confidence.

Though honest disagreements will occur, the best companies don't shy away or selfishly frustrate efforts to compel better industry practices. These companies recognize that they are the first to benefit from better standards, especially if their business requires extensive dealings with partners or counterparties. But, we have to recognize a higher responsibility: to speak up, to draw attention to potentially destabilizing trends and to act like an owner responsible for the integrity of the system.

I, for one, know we have not done the best job in the recent past but working with you, as many of the world's most important investors, Goldman Sachs pledges to recommit itself to this fundamental obligation.

Thank you very much.