PANEL 2: FINANCIAL REGULATORY REFORM – PROSPECTS AND PERSPECTIVES

Moderator: Geoffrey P. Miller
Panelists: John C. Coffee, H. Rodgin Cohen, Joyce E. Hansen, Annette L. Nazareth, Bradley K. Sabel

Geoffrey Miller: It's a real pleasure to be here. I must say my topic of banking regulation didn't used to get such a crowd. "Never waste a good crisis" is my attitude about that. So we enjoy our brief moment in the sun, those of us who do bank regulation. We have an all-star panel here. I will describe their backgrounds as we go along, but they are in your brochure. We're also delighted to welcome Joyce Hansen, from the Federal Reserve Bank of New York—Joyce has very generously agreed at the last minute to substitute for General Counsel Tom Baxter who is unavoidably absent. So thank you very much for standing in.

Our topic is unbelievably timely. Most people here probably are aware that yesterday the President announced proposals for sweeping reform of bank regulation—two of them in particular. One, something he called the Volcker Rule named after Paul Volcker, former Chairmen of the Fed, now senior advisor to the Obama administration, would prevent commercial banks and financial institutions that contain commercial banks from engaging in proprietary trading operations or sponsoring hedge funds or private equity enterprises. That is one very significant reform that was proposed by President Obama.

The second, addressing the "too big to fail" problem, calls for a cap on the total market share of non-deposit liabilities of any individual bank or financial firm. Again, very, very significant structural reforms; not one but two proposed yesterday by the President of the United States.

We're going to have this panel in something of a discussion format. I'm going to ask questions; the panelists will answer them as fully as they're capable of doing, and they're very capable. Then we'll have the opportunity for some give-and-take with the audience.

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So with that I will ask my first question. Rodge Cohen, to my right: Rodge, you are one of the leading banking lawyers in the United States, if not the leading banking lawyer, and also over the past couple of years you've become something of a celebrity featured in major media. I'll just mention a few comments about Rodge. One from the New York Times, from November of 2009: "Mr. Cohen's influence over Wall Street is both legendary and pervasive, reaching back to the 1980s when he helped to consolidate the industry, and then to the 1990s to shape the regulatory scheme that permitted last year's unprecedented outlay of federal dollars."[1] And, just to be complete in New York, the Wall Street Journal, October 9, 2008: "With virtually all of Wall Street as his client, [Mr. Cohen] has solidified his role as one of the most influential private-sector players in the financial crisis. Over the past five weeks alone, Mr. Cohen and his team have advised Fannie Mae, Lehman Brothers Holdings Inc., Wachovia, Barclays PLC, AIG, J.P. Morgan Chase & Co. and Goldman Sachs Group Inc. in a blitz of mergers, rescues and cash infusions."[2]

Well, here's a question for you: You have many of the leading financial firms in the world as your clients. We have seen a lot of sound and fury, but as yet very little change either in the law or the written regulations, but that doesn't mean there hasn't been change, because change can happen in what regulators do as opposed to what they are supposed to do under the law. So my question for you is have you observed any significant changes in the intensity or type of regulatory scrutiny being given to your clients? And, if so, how do you evaluate that?

Rodge Cohen: Well, to begin with, that is a very perceptive question because everyone focuses on what has not happened, which is we don't have legislation, we really have very little in the way of new regulation, but what we do have is a pendulum change in supervision. We have the regulators going to financial institutions, particularly banks, around the country and imposing higher capital standards quantitatively, with an em-

1. Alan Feuer, *Trauma Surgeon of Wall Street*, N.Y. TIMES, Nov. 13, 2009, *available at* http://www.nytimes.com/2009/11/15/nyregion/15cohen.html.

2. Matthew Karnitschnig & David Enrich, *A Lawyer for All Wall Street Navigates Tempestuous Times*, WALL ST. J., Oct. 9, 2008, *available at* http://online.wsj.com/article/SB122351145980417529.html.

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phasis on the highest form of capital which is common equity. We have the regulators being far more intrusive into corporate practices than they have ever been before. I don't think I ever remember a regulator, prior to the last year, ever inquiring about compensation practices, much less setting out new guidelines, which are quite sweeping and extensive. You have regulatory pressures to write down loans to a greater extent, to write them down sooner, to adopt higher loan loss reserves. This is not an unusual phenomenon. Every time there is a financial crisis, the supervision quite naturally becomes much more stringent. For those who would say it is just business as usual, believe me, it is not.

Geoffrey Miller: So just a follow up question on that. It's not business as usual; the regulators are greatly increasing the severity, intensity and scope of their supervision of banks. Isn't this problematic, because maybe this ought to be the time when the regulators allow banks more leeway, not less leeway, to make loans in order to help us get out of the financial slump we've been in? Isn't this a pro-cyclical act by the regulators that achieves exactly the opposite of what we ought to be looking for?

Rodge Cohen: There is certainly a real danger in that. The objective as always should be balance. But when regulators go as they do to banks and say we don't want you to make a single new commercial real estate loan, that's a real problem because there are a lot of commercial real estate loans that need to be refinanced. So you always worry about pendulum swings one way or another. You don't want them going to the extreme, and not surprisingly, I believe it is going to the end which has exactly the pro-cyclical impact to which you refer.

Geoffrey Miller: Okay, thank you for those comments, and we'll have a chance to follow up on those as we go along. Brad Sabel, you spent eighteen years of your professional life working at a little institution on Maiden Lane known as the Federal Reserve Bank of New York, and since then you have spent sixteen years in the private sector. So I guess you have about equal balance between the two, giving you almost unique ability to assess your former employer and its performance.

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Now, one of the proposals that has been on the table in policy circles is that the Federal Reserve institution generally ought not to exercise the type of banking supervision powers which it has historically exercised, which have seemed to steadily increase over time. Rather, it should become like the Bank of Japan or the Bank of England, or the ECB—the European Central Bank; a central bank, not a bank regulator, and the function of bank regulation should be given to others, perhaps a specialized bank regulatory agency. This is obviously a highly controversial political question, both in the United States and in Japan, and in Europe. Putting aside what is obviously going to be your lingering affection for the Fed, Brad, what is your assessment of that? Would that be a good thing to return the Fed to its role as a specialized central bank and to give the bank regulatory functions to others?

Brad Sabel: I go back and forth on this. I went back and forth on this when I was at the Fed and I have gone back and forth since then, not without some trepidation, but I would be in favor of taking them out of supervision. There are several—

Geoffrey Miller: I should warn you that you have an officer of the New York Fed sitting next to you.

Brad Sabel: I know, I know. I was going to ask that she sit over there.

[Laughter]

No, and it's not so much because they don't do a good job—I think that they by and large do, although you can have a lot of debate about it. What I worry about is the political effect, just the politics of this country. The Fed, of course, treasures its independence in conducting monetary policy, setting interest rates, money supply when they did that, and being able to control inflation as best they can with very little political interference. Their regulatory role, I think, in a lot of cases interferes with that. I saw too many cases when I was at the Fed where there was some huge bank problem, much like what we have now but obviously not nearly at the same scale. But Tim Geithner pointed at one or two particular banks where the argument was made that the Fed screwed up, that the Fed made a mistake and why did this happen. There is this aura to the Fed, to the Secrets of the Temple, which was a very good book that was written about twenty years ago, about the

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Fed and its independence and how it operates; the problems that can come up, if there is a problem in a bank, can be used against the Fed. There have been cases where Congressmen have used that as an excuse to try to hem in the independence of the Fed.

I think that the result is that the Governors, who, frankly, are there not because they love doing bank supervision—they are there because they want to be able to implement monetary policy—don't want to take chances. They don't want to take risks. And as a result, they can come up with some very strict rules to basically avoid any kind of a problem ever happening, so that it doesn't get used against them as an excuse to hem in their monetary policy authority. I think that the better thing to do will be to take them out of that role. I would give them the control of the payment system—I think that's integral to them—but I would take them out of the supervision business.

They've always said that it's a three-legged stool: you need to do monetary policy, control the payment system, and regulate banks in order to do any one of the other two things well. You just need to have this all done in one place. I think there is something to that. I think that there is a lot of experience and first-hand knowledge that the Fed gets from supervision which they do use in their jobs. The question is do they really need to have that in order to do their jobs? Why can they not rely on one or more other agencies? Right now, the Fed gets exam reports from the OCC on national banks and from the FDIC for state nonmember banks, and they study them and they know what they say. It's not quite the same thing as having your own examiners in there writing them and having your own people being able to go in and do what you want. You might have to go to others, but wouldn't they be able to be in effectively the same position even though they are getting this information second-hand?

So, and again not without trepidation, I would take that away from them. That has really been the trend until recently with other central banks: Bank of England got out of it, Bank of Japan. Bank of Canada I don't think ever did have it. So it definitely can be done. Those countries by and large get along just fine, and I think we probably would too.

Geoffrey Miller: Well, a follow-up question: two arguments are heard most commonly in favor of the Fed being in-

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volved in regulation. One you alluded to, which is that to conduct monetary policy the Fed needs all sorts of information, and its function of regulating the banking system, especially the very large banks associated with bank holding companies, gives it necessary information that can be used and folded into the process of formulating monetary policy. Now you mentioned that the Fed might be able to get that information from other parties but an advocate of Fed regulatory power might respond by saying you can get a report from the OCC but it's not the same thing as sitting down with a banker in a regulatory environment, the quality of the information isn't the same, and also we all know that in Washington, agencies may say they are going to share information but it doesn't mean that they do share information. If the information about the underwear bomber couldn't be shared among the defense and intelligence establishment, how can we assume that information will be shared among the banking agencies which, as we all know, have rivalries that far exceed in intensity and animosity anything that characterizes our national defense establishment?

[Laughter]

Brad Sabel: Well, my response: I don't buy it. If the Fed wants to go out and talk to bankers, the Fed can go out and talk to bankers. And they do that all the time. They talk to dealers–you know, they are the central bank. People like to talk to the central bank, it makes them feel important. They give some good information. They often get some good feedback. And we know the Fed will not be cut off from talking to the bankers. I acknowledge that of course there can be delays in getting information. There can be problems. But you would have to set up a mechanism to make it part of the routine that they really do have to share. It's, like I said, not without trepidation—things can go wrong, but I think that that can be overcome.

Geoffrey Miller: Joyce Hansen: So you've been Deputy General Counsel and Senior Vice President of the New York Fed since 1993 and you are responsible for the legal department's work and support of the New York Fed's bank supervision, markets and research groups. Now among the more controversial decisions during the crisis that happened in Fall of 2008 were the decisions by the Fed to provide emergency li-

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quidity support in connection with the resolution of Bear Sterns, and to not provide such support in connection with the failure of Lehman—and this raised in many people's minds a question. Many of us, myself included, had not focused on the fact that buried in the interstices of the U.S. Code was a little law called Section 13.3 of the Federal Reserve Act, which seemed to give the Fed the power in 2008 to basically be the godfather of the world's financial system—a power so exceedingly great that one would have thought that people would have focused on in the past. But we didn't.

But when you go and look, we find that under this Section 13.3 of the Federal Reserve Act, the Fed has authority in unusual and exigent circumstances to provide liquidity assistance, not only to banks but also to non-bank institutions which are able to establish that they are not able to get funding through the banking system by other means. So this is really an extraordinary authority that the Fed had in its pocket for a very long time, and brought out and exercised in 2008. Some have called for this authority to be cut back or eliminated on the ground that rescuing non-banks is not part of the Fed's mandate and should not be part of the Fed's mandate.

So my question to you, Joyce, is should Congress cut back on Section 13.3 of the Federal Reserve Act? Would it be a good idea to deprive the Fed, to deny it the power to make temporary liquidity assistance available to firms such as Lehman, Bear, or AIG?

Joyce Hansen: Thank you. First of all I have to give the disclaimer. I am here speaking in my own capacity and any of the opinions I express are solely my own and should not be attributed to the New York Fed or the Federal Reserve System. But I look forward to answering your question and I do have a few slides.

Geoffrey Miller: So by an amazing coincidence Joyce happened to have prepared slides pertinent to the very question that I asked.

[Laughter]

Joyce Hansen: These slides are really to keep me on track, but it gives you something to look at too, while I'm talking. Thanks to my colleague who is going to flip them for me. What I'm going to do is talk a little bit about this authority and

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how we used it and just look at how the Wall Street Reform and Consumer Protection Act would propose to amend this 13.3 authority and what impact that would have on how we would use it if that law were enacted.

Now when I talk about this 13.3, I like to start with the statement actually that Chairman Bernanke made at the beginning of the financial crisis. He said, "We will do whatever it takes within the bounds of our legal authorities to address the crisis and restore financial stability." I find that to be an incredibly powerful statement. I think it's powerful not only because of its courage and conviction, but also I take great pride in it as a lawyer—because of its commitment to the rule of law and his explicit mention of legal authority. I can't tell you why he said that, but obviously no one would have thought that he was promising to act without the bounds of law if he hadn't put it in there, but I think it's an important statement about the Fed and how it would use its authorities, wherever it could, to stem the crisis. And in truth, to respond to the crisis, the Fed authorized a multitude of liquidity facilities to help address the funding strains in the market. Those not only experienced by certain financial institutions but also by markets more generally. And the vast majority of these facilities were authorized under 13.3.

I have up on the next slide—this is actually from our website. These are all of our liquidity facilities that are in effect now, with one exception. Some of them are about to expire according to their terms and the board has indicated that it is probably prepared to let some of these expire. Not all of these are 13.3, but most of them are. And most of the ones on this chart are facilities that were available to the market. They were intended to provide liquidity to a market, as opposed to a specific, individual institution.

A couple I might highlight would be, for instance, the primary dealer credit facility and the terms securities lending facility, both of which were available to primary dealers. There were great strains in the repo financing market, which is a key financing market for those dealers. And that facility was intended to relieve pressure in that market, similarly with the terms securities lending facility. But we had other facilities, one directed to the commercial paper market, one that's directed to the securitized assets market, which is one of the

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more recent facilities. And they were all sort of geared towards markets.

But that's not to say though that 13.3 wasn't used for individual institutions as you mentioned, Geoffrey. And actually 13.3 was the basis of our authority to lend to facilitate the acquisition of Bear Sterns by J.P. Morgan Chase. In fact, it was that March weekend in 2008 that we first implemented the terms securities lending facility and the primary dealer credit facility, which is this repo market facility. And of course it is the source of our authority to lend to AIG.

One thing I want to spend a little more time on, because I think it's sort of key when you look at how our authority might change under 13.3 and what the implications of that are, is the Lehman example. I think it's something people don't focus on particularly well. On Lehman weekend, or Lehman Monday—Monday, September 15th—the holding company filed for bankruptcy. A number of subsidiaries did—their derivative subsidiaries, and a number of subsidiaries holding real estate; and in London their major broker-dealer filed for bankruptcy. In the U.S., the U.S. broker-dealer did not file for bankruptcy. And there was a reason why it didn't file for bankruptcy and this reason is one reason why commentators would say the results in the U.S. and London, and the impact on the market from that filing, differed so substantially. At that time we had the primary dealer credit facility, and in consultation with Lehman's primary regulator, we agreed that we would use that facility to enable Lehman to continue doing business over the course of a short period of time. The purpose of that was to allow them, outside of a bankruptcy process, to wind down their book in an orderly way. I think what we're all looking for in a crisis situation of this nature, when you look at changes to our resolution authority, the goal is always an orderly wind-down. And there were many that thought that a filing, particularly under SIPA, would not result in an orderly wind-down in this case. So we were willing and able to provide that liquidity at that time to allow them to shrink their book, to prevent some negative consequences and externalities in the repo market that would affect many, many participants in the market: not only dealers but investment funds, mutual funds, money market mutual funds, which are large participants in that market, and there would have been a wide, wide financial impact.

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What happened later that week was that Barclays, which had been initially interested in acquiring the entire Lehman organization over the weekend but had dropped out from that, came back and actually acquired most of the assets and liabilities of the primary dealer. And then the rump organization is now in a SIPC proceeding being wound down. So, what would happen under the new Section 13.3 in the bill as passed by the House, if that were adopted?

Before I get into that, the lesson I take away from the use of our 13.3 authority is that it has enabled the Central Bank to provide time for an orderly wind-down in many circumstances. It also was important for the Central Bank to act quickly. So what the Central Bank provided was time and liquidity, and those are two key issues in dealing with a financial crisis and restoring confidence to the market.

There are a number of changes both on the procedural level and on the purpose level that would come into place if the Statute as passed by the House were enacted. The procedural ones, I think, affect the ability to act quickly. They're not necessarily things that are good or bad in and of themselves. They are procedural hurdles and there is something very similar to what the current systemic risk determination in the FDI Act is, which is that there would be a two-thirds vote of the new Systemic Risk Council and written consent of the Treasury Secretary that a destabilizing liquidity event exists. Now of course, when the Fed has acted in this way you know that there has been close consultation with other parts of the government, including Treasury. It also requires a finding by each board member—under the current 13.3, five board members must vote to exercise authority. So this is expanding on that requirement that they approve the emergency financing, and that they and the Secretary of the Treasury agree that there is a 99% likelihood of repayment of principal and interest, which obviously affects the ability to act quickly because there is a fair amount of analysis that would need to go into that. Although under the current authority, the Fed must be secured to its satisfaction and we always seek to have the highest amount of security we can. Congress can then adopt a joint resolution of disapproval.

There are a number of other issues and requirements, and they are listed on the next slide. I would focus on one of them in particular, and that's the purpose. Now, when I

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talked about our use of 13.3 under the current authority, I pointed out the table with all the liquidity facilities that are aimed at the market. Those would still be permissible uses of 13.3. What would not be permissible under the new 13.3 is lending to an individual corporation, partnership, or individual. That would mean that there would have to be some sort of general facility that is widely available. I would go back then to the Lehman example. If you look at that example, we did have the primary dealer credit facility, it was a widely available facility that was in place at that time. Even when we have such a facility, it's always within our discretion to allow a particular institution to use it, and working with the primary regulator, we agreed to let Lehman use it to achieve this orderly wind-down purpose. In the absence of being able to make the findings under the new statute that such a facility should be authorized for the market, I think going forward our ability to lend to an individual institution, in particular a broker-dealer having liquidity concerns, would be at issue. So you look at our actions in that case and I think our ability to act in that way would be impaired.

There is also an irony to this, because the last time 13.3 was amended was in 1991—and 1991 was shortly after the market break of 1987—and what was the purpose of that amendment? The purpose of that amendment was to remove some limitations in 13.3 on the kind of collateral that the Reserve Bank could take. And the reason that was eliminated was so that the Fed, assuming the circumstances in 13.3 were in existence—that is, urgent and exigent circumstances and inability to get credit accommodation from another source—if those requirements were met, the Fed could lend to a broker-dealer. That was precisely the reason. So that I see as being kind of a rollback in the ability of the Fed to respond quickly to a crisis to help resolve an important and systemically important institution in the future. I think it will be more difficult. What you have to do is look at other parts of the statute, such as the resolution authority, and I believe Mike Krimminger is going to be talking about that in the next panel, as to whether that in fact provides a basis to deal with this problem going forward.

Geoffrey Miller: Thank you Joyce. Maybe you could clear up something that people have wondered about. My understanding was that a reason, if not the reason, that the Fed did

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not provide assistance to Lehman Brothers—not its broker-dealer, but to Lehman Brothers itself—was that it concluded that it could not satisfy itself that it had adequate collateral. Is that a correct assumption about why the Fed did not provide assistance to Lehman Brothers, and if so, would you recommend revising the law to permit that kind of assistance in the future?

Joyce Hansen: Well again I think we have to step back a minute and look at what was going on that weekend. That weekend started, probably mid-week, when that particular institution was suffering from very stressful conditions and liquidity demands, and it looked like perhaps it was not going to make it. The strategy of the U.S. Government that weekend was to try to find a private sector solution for the acquisition of Lehman Brothers. So in fact a large group of financial institutions were called to the Fed that weekend and told by the current Secretary of the Treasury and other public officials that their job was to find a solution by the end of the weekend for Lehman. There were a number of plans that were put into effect that weekend. There was two banks that were very interested in acquiring Lehman. There were issues with some assets that some of those acquirers didn't really want to have. There was a private sector group that had been tasked with coming up with a way to deal with those toxic assets, for lack of a better term, and there was actually a solution to that put forward, and it was moving along quite nicely. That was Plan A.

Plan B was, of course, if Plan A fell through, a potential bankruptcy filing. And unfortunately Plan A fell apart. It fell apart for a reason that is very hard to explain; at least it's very hard for me to understand. Again, you have to go back to March 2008 and the Bear Stearns weekend. There was a private sector solution there: JPMorgan Chase acquired Bear Stearns. And a very key part of that, which I think a lot of people don't focus on, is that in between the time of the announcement of the acquisition and the closing of the acquisition, the acquirer issued a guarantee for all of that institution's trading counterparties. So it is very important for an institution like this to be able to continue to do business—whether it is winding itself down, which Lehman Brothers was doing with the help of the Fed, or if it is going to be acquired and there is time to consummate that acquisition. There were a number of

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legal issues that arose with respect to any potential acquirer, or the most interested potential acquirer, as to whether that guarantee could be issued. Therefore the solution unwound itself very quickly.

But just looking at how that happened, the lesson is that you need time, you need liquidity, and you do need someone who is able to support that institution going forward, and there was really no one who could step up to do that, or who had the authority to issue a guarantee to allow that institution to keep going. The Fed doesn't have that authority, and at that time, the TARP legislation hadn't passed so the Treasury did not have that authority either.

Geoffrey Miller: Annette Nazareth. Joyce several times mentioned a certain primary regulator, and she didn't say who that primary regulator was. I'm kind of thinking it was the SEC. Joyce, is that fair to say?

Joyce Hansen: Yes.

Geoffrey Miller: So, the primary regulator is the Securities and Exchange Commission. Now, you are a former Commissioner of the Securities and Exchange Commission, and currently a partner at Davis Polk. So you have a different background, perhaps, and a unique background, having both the private sector and very high-level government experience—it's certainly different than others on this panel. One of the more controversial and little-understood aspects of the Crisis of 2008 was the role played by over-the-counter derivatives, including credit default swaps and similar securities. These are very controversial; there have been many proposals to cut back on them, to subject them to insurance regulation, to create an explicit trading-floor type market for them. Whatever is done is going to, in my opinion, dramatically change the way in which over-the-counter derivatives are marketed and traded, and potentially change it in a groundbreaking way. What is your view on what is going to happen and what should happen in this area?

Annette Nazareth: I certainly think that of all of the proposals being considered, it is remarkable how groundbreaking the regulation of derivatives will be, and yet it is probably one of the provisions that, to some extent, is widely believed as inevitable and necessary. So there may be controversy around

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elements of it and particular provisions, but I think there is a general recognition that when you have a three hundred trillion dollar notional market in the United States of financial instruments that are risk instruments, that requires some regulation.

When I say that, it sounds so patently obvious, but it is remarkable to think back to 1999 when Congress determined through the Commodity Futures Modernization Act that the securities and futures regulators would not, and no regulator would, have the ability to regulate those markets. When you think about what regulation entails, it involves more than just regulating the participants in that market; it involves regulating the markets themselves, the clearing houses. It means regulating the market data, and the transparency, and the behavior of all the participants. So there is a huge amount of regulation that I believe will come about in this legislation.

There are certainly some areas of controversy. I don't think it's considered controversial that swap dealers will be regulated, but certainly there will be issues around major swap participants and how to define those people, who gets picked up by that, and what kind of additional regulation—whether it's direct oversight or limits on margin or having capital requirements—what types of provisions will apply to those active participants in the market, however you define them. Ultimately, there has been a lot of focus on end users—what about commercial enterprises that use swaps to hedge their risk? Are they going to get swept into this regulation? And if they are, will it not only increase the costs of them participating in that market and increase their costs of hedging but will it also discourage them from engaging in risk mitigation activities? So, there's going to be quite a bit of debate around the edges of this. But in general, I think this will certainly move forward.

I have to add, from my prism as a securities regulator, that it is somewhat disappointing in the context of all this that we haven't used it as an opportunity also to rationalize the regime somewhat. When you look at a three hundred trillion dollar notional market and you talk about, now, splitting the oversight of that market between two regulatory agencies, it goes back to the earlier point that we can talk about information sharing all we want but the fact of the matter is that if you have one holistic market and you artificially divide who is going to regulate that market by virtue of political compromises, I think

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what you also compromise is the ability to effectively oversee that market and see interrelationships between markets.

For example, the proposed legislation appears to divide securities based swaps and other swaps in a way that is not necessarily as you would expect. "Securities based swaps" is defined quite narrowly, and thus you could have a lot of oversight of swaps that have a lot of security components to them. indeed, broad based security swaps would be overseen by the CFTC, where the underlying equity, the cash products, would be overseen by the SEC. Again, is it possible for them to share information for purposes of overseeing those markets? Yes, it is possible. Is it likely? It will take a great deal of time to achieve those goals. I guess the question is: is that the smartest way to do it? But that is just my editorial comment on it all.

Geoffrey Miller: So how would you respond to a regulatory skeptic who might say, the fact that the U.S. Congress is certainly going to regulate these things doesn't necessarily mean that it's a good idea. Congress does a lot of things that aren't good ideas. So I wouldn't say that the fact Congress is going to act means it's a good idea anymore than the fact Congress isn't going to act means that it's not a good idea. At the same time, you mentioned that it's a three-hundred-trillion dollar notional amount market. But the fact that it's a very large market doesn't necessarily mean that it ought to be regulated, or suggest by whom it should be regulated.

Did this market break down in some pernicious way that contributed to the problems that we experienced in 2008, or is it at risk of breaking down in a pernicious way if not regulated going forward? What was wrong with this market? Why don't we just leave it alone?

Annette Nazareth: Well, I think there were very significant risks in the market. Some of which would have been really disastrous if the New York Fed and others had not taken a lead before the crisis, and sort of forced—on a more consensual best practices effort—to get the major swap dealers to improve some of the basic underpinnings and plumbing of the marketplace. The fact that the documentation was so pervasively delayed and insufficient and the fact that novations and assignments were not documented—had that not been corrected to a large extent before the crisis, I think we would have been in far, far worse shape. And it just goes to show that we have a

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marketplace that far exceeds, not just the regulatory underpinnings, but the operational underpinnings much, of which are often regulatorilly mandated in order to support that market.

So we certainly have some issues that I would say regulation would have prevented but I also think that it is not for us to wait for the next crisis to discover what other issues regulation could have addressed.

Geoffrey Miller: Jack Coffee. Jack brings to this panel an academic perspective. Now, sometimes I deal with practical lawyers, and when you talk about an academic perspective it is close to an insult. If they say, "Shall I call you *professor*?" usually that means, "Are you a completely out of touch, pointy-headed intellectual, with absolutely nothing of interest to say?" You've probably experienced that also, Jack.

Jack Coffee: Are you denying the truth of that?

Geoffrey Miller: With respect to you, yes. This is not true of Jack Coffee. He is a law professor, but he's a lot more than that. So I'm going to quote to you from a recent publication about Jack. It says, "Professor John C. Coffee Jr. has a disc jockey's voice and a mischievous wit. The Adolf A. Berle Professor of Law and the director of the Center on Corporate Governance, Professor Coffee is at ease in many disciplines. His academic work is informed by continuing participation in live legal cases. He is superhumanly prolific, and he is regularly cited by the courts and quoted in the press."[3] Well, I expect that Jack will bring his mellifluous voice, his sharp wit, and his superhuman prolificacy to bear in answering my question.

So this is the question. We have talked a lot about regulation of banks and financial institutions in general, but the crisis of 2008 was broader than financial markets only, and the proposals to do something about this crisis have also been broader. For example, we've heard proposals about executive pay. So far they have been limited to financial firms, but why? They could easily go beyond proposals for using corporate governance reforms as a way of controlling or limiting the propensity toward excessive risk taking that was observed, in the view of many, in 2008. So could you possibly give us the

3. Adam Liptak, *Jack Coffee, Corporate Gatekeeper*, http://www.law.columbia.edu/law_school/communications/reports/winter07/jackcoffee.

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broader perspective, from the Ivory Tower, of what else we need to think about when we consider going forward, what we should do?

Jack Coffee: Funny that you should ask that question because it more or less fits what I was going to say. We've been hearing a lot of inside baseball about the New York Fed, but at the end of day, you can wind up missing the forest for the trees, even though each tree is fascinating. So I'm not going to take the classic academic perspective which is to give you a view from about 200,000 feet and announce the earth is round but the institutional detail is invisible from up there. This is the view from about 50 feet, just about over the treetops of the forest, and the critical question here is how do we explain the financial meltdown which witnessed a large number of seemingly rational, usually well-run financial institutions all taking on excessive leverage and excessive risk. What explains that?

There are, I think, three popular explanations. I've testified before congressional committees and they all know these three very well. I'm going to suggest that these three don't explain enough and there is a fourth explanation that explains more but it's less politically popular.

What are the three explanations for the financial meltdown? The first one that everyone in the White House and everyone in Congress will jump on is lax regulation. They will say that after 2000, a group of financial regulators, not just one but a group, all excessively deferred to self-regulation and therefore financial managers were able to take on excessive leverage. I understand and thoroughly agree with what Rodge Cohen said that this has probably changed and we are now going to see much more intensive scrutiny. But the one thing about regulatory scrutiny is that it is not a constant. The intensity of regulatory oversight waxes and wanes. I think it follows a sine curve, going up after crisises and sooner or later waning as the forces of deregulation come back. Even though there has been reform, I think this is a problem that will predictably re-appear. Moreover, it reverses the cart and the horse to begin with lax regulation, because regulation is a fallback, a safeguard. What went wrong at these firms first?

What caused this rush towards excessive leverage? Well here the second popular explanation, and Lucian Bebchuk would have given it if he were here today, is executive compen-

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sation. Lucian sketches out a very plausible case that excessive compensation—particularly excessive short-term compensation in the form of bonuses and stock options—incentivizes managers to pursue short-term profitability and to ignore longer-term losses and liabilities, so there was a misalignment between the interests of managers and the interests of shareholders. I tend to think there is a lot to what Lucian is saying but it really doesn't apply very well to the world of financial institutions. That is villain number two, executive compensation.

Villian number three is the failure of technology. This is sort of the Sorcerer's Apprentice story—the quants who designed all of the financial technology underlying AIG didn't really understand how the market worked and so their model didn't account for some of the institutional realities; thereby they raced off the cliff and suddenly faced exposure to 80 billion dollars or so of credit default swaps that they couldn't pay. There is something to that, their model didn't work. I think the conflict of interest story overlaps with this story and may better explain why the people at AIG Financial Products would design the flawed model that they did because taking high risk for their firm earned them high short-term compensation. .

Those are the three most popular villains: lax regulators, executive compensation and technological failure and excessive reliance on the quants. There are, however, problems with each of these that I will get into in a minute, but there is a fourth villain that no one in Washington wants to talk about, and that is simply: shareholders.

The fourth scenario that I want to give you is that shareholders in the capital markets pressured managements to accept undue risk because shareholders tend to be risk neutral. That is fine in the ordinary world of corporate governance where shareholders are risk neutral because they are diversified. The problem is financial institutions cannot be risk neutral because they are just too big to fail. They have to be more risk averse than that corporation making widgets. You will notice that these stories are to some degree complementary, we can take a classic figure—Stanley O'Neill, the CEO of Merrill Lynch, who quarter after quarter saw that Merrill Lynch was falling behind Goldman Sachs and it's stock price and it's profitability. Maybe he was pushed by all of these forces—he was pushed by shareholder pressure, pushed by executive com-

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pensation—to cause Merrill to chase after Goldman and rush into a market that was already beginning to crater, and vastly overextend the company to become now an underwriter of CDOs rather than simply a retail broker-dealer franchise.

So he made the wrong strategic decision because he was pressured both by executive compension and by shareholder pressure. How do you decide which story has the greater relevance—because different reforms are necessary depending on which story gets the greater weight. Here is where there has been some very interesting recent academic research. Rene Stultz and Andrea Beltratti published a paper late last year called *Why Did Some Banks Perform Better during the Credit Crisis?*,[4] in which they examine every plausible hypothesis you could give for why financial institutions would encounter this sudden financial meltdown—and they looked at the stock price returns on basically all large banks worldwide, not just U.S. banks. They look at the period between July 2007 and December 2008, which is certainly the relevant period to look at. They find only one story that really holds up and yields regression results that are statistically significant. They find essentially that banks with the most shareholder-friendly corporate governance performed the worst. The more "friendly" they were to shareholders, the more shareholders appeared to have pressured those banks to take on excessive leverage, excessive risk and the stock price collapsed during this period. So, not only regulators but shareholders appear to be a problem.

In a parallel study, done by Stulz and Fahlenbrach, they examine what I'll call the specific Lucian Bebchik thesis. This paper is called *Bank CEO Incentives and the Credit Crisis*,[5] in which they go through major banks during the 2008 credit crisis and relate it specifically to the compensation and stock ownership of bank CEO's. Here is what they found: "There is no evidence that banks with CEOs whose incentives were bet-

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4. Andrea Beltratti & Rene M. Stulz, *Why Did Some Banks Perform Better during the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation* (July 13, 2009), *available at* http://ssrn.com/abstract=1433502; *see also* Andrea Beltratti & Rene M. Stulz, *The Credit Crisis Around the Globe: Why Did Some Banks Perform Better?* (March 16, 2010), *available at* http://ssrn.com/abstract=1572407.

5. Rüdiger Fahlenbrach & Rene M.Stulz, *Bank CEO Incentives and the Credit Crisis* (December 17, 2009), *available at* http://ssrn.com/abstract=1439859.

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ter aligned with the interest of their shareholders performed better during the crisis."[6] Indeed, they find some evidence that they perform worse. So all the stories about option compensation and bonuses may have some value but it doesn't work to explain what happened at all these banks worldwide. We tend to find that all of them went the same way regardless of CEO compensation. That points you in the direction that something else, something deeper, perhaps shareholder pressure, capital market pressure, may have pushed banks to take excessive risk.

A few weeks ago there was another parallel study by three University of Southern California financial economists that used a database from 296 financial firms from 30 countries and they find that shareholders encouraged investments in subprime mortgage related assets that led to large losses during the crisis.[7] They found the evidence consistent with shareholders having encouraged managers to take aggressive risk. They do not find evidence that boards or managers themselves were the source of this pressure. In sum, two common denominators appear in these and other recent academic studies: first, shareholders bear at least much of the responsibility for excessive leverage and excessive risk taking and second, the executive compensation story, focusing exclusively on CEO compensation doesn't find much support.

Now I'm not trying to exclude the possibility that executive compensation was a factor, but I think there is subtler story about executive compensation that other researchers have pointed to. It's not the CEO story; it's a broader story about middle-level or secondary managers. This story, which Professor Steven Schwarcz has advanced, looks at what happened at financial firms over the decade, and it finds that after 2000, those firms began to compensate their middle-level managers for increasing profitability without increasing the firm's risk profile. The firm's risk profile is measured by a metric called Value at Risk or VAR, and so mid-level managers quickly responded to these incentives by seeking to increase profits at

6. *Id.* at 1.

7. *See* David Erkens, Mingyi Hung, & Pedro Matos, Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide (May 2010), *available at* http://areas.kenan-flagler.unc.edu/Accounting/Documents/Erken-EHM%20May%202010.pdf.

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their division without using any financial product that increased their VAR.

What is the name of the unique financial product that does not increase your VAR? Its name is credit default swaps. Because credit default swaps didn't raise the VAR level, but did increase profitability, heavy reliance was placed on them, even though the managers knew that if these things went wrong with credit default swaps, they would go catastrophically wrong and fast. So there could be a lot to the executive compensation story but we've got to move beyond simply "the CEO did it all." There are other people to worry about than simply the CEO.

If this is what the evidence seems to show, then what are the policy implications that flow from this view? Well if the shareholders and their appetite for risk is a large part of the problem, financial institutions probably need to be insulated from shareholder pressure, or at least shareholder pressure for short-term return and increased risk. How do you do that? Younger academics who want to write a very high profile provocative article would probably publish something saying we ought to have mandatory staggered boards because mandatory staggered boards would spare managers and financial institutions from shareholder pressure. I'm just a little too old to turn around and endorse staggered boards at this point in my career. But the idea here is that there probably needs to be some insulation of financial institutions. They are different from other areas of corporate governance. Other areas of corporate governance let the shareholders decide. We can't allow shareholders to decide the fate of financial institutions or their risk exposure because they are too big to fail and, when they fail, we always end up socializing the losses by spreading it over the broader community.

Now notice what I just told you—we need to insulate financial institutions from shareholder pressure because shareholders being diversified will always pressure for too much risk. This is not the story that Washington wants to hear right now; this is not how you tap into the populist anger. This doesn't have an easily visible villain, but if we are going to actually make financial institutions more prudential and less risk taking during periods of crisis, we cannot leave them just like Amalgamated Widget exposed to the Carl Icahns of this world. If you want to make a short-term profit in any corporation,

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including a financial institution in particular, you increase its level of leverage. That is not what we can tolerate in the world of large tier 1 banks, but it was something that was happening at all of these firms. So I'm giving you what I think is the correct analysis of what happened and it may be the most impossible and political goal of all to say right now that we have to constrain shareholders so they cannot pressure management to increase leverage or assume all the risk that risk neutral shareholders can willingly bear. On that pessimistic note, I'll turn it back to you, Geoffrey. .

Geoffrey Miller: Think about the implications of what Jack has said. The whole force of the corporate governance movement for the past 25 years has been to align the managers of companies with the shareholders. Jack is saying let's not align them. A fundamental challenge to principles of corporate governance that have been widely accepted in other areas and Jack has raised with respect to financial institutions.

So there are two possible reasons why shareholders might encourage managers of financial institutions to take too much risk. One is the rational explanation which is if you're highly leveraged the shareholder effectively has a put option—if the company does really well, the shareholder will take the lion's share of profits. If the company goes broke the shareholder will only incur a small percentage of the downside, so it is in the shareholders' interest to take excessive risk. That is a rational explanation of why shareholders might prefer managers of financial institutions to take on a lot of risk. By the way, many companies, not only banks, are leveraged and the same principle would apply to any leveraged company.

Jack Coffee: But they're not too big to fail.

Geoffrey Miller: Okay. The second explanation for shareholders wanting managers to take too much risk is that they have been reading all this stuff about making a lot of profit and they don't know what they are talking about, they're not behaving rationally; they're just going along with the general spirit of a bubble economy and wanting very big returns—irrationally—because getting those kinds of returns ex ante would be a negative in the shareholders' long range interest. So, Jack, do you know which of those it would be or do you have any views on that?

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Jack Coffee: Well I think it can be both. I'll take your second theory to be one under which there might be short-term investors, including activist investors, particularly at hedge funds, who think they can get the stock price up for the next quarter or two if they can get the firm to take on more leverage. They do not fear for the long-term future because they never hold for more than a month or two. This story is a variant on a standard "moral hazard" story, and it is certainly plausible, even if it has not been proven by regression studies. There could be that scenario too. Either way we are talking about a world where because the financial institution is unique—it is too big to fail—we wind up socializing its losses. I think we need to have a different attitude towards risk-taking at financial institutions than we do in the world of normal corporate governance. In other words, what I'm saying bluntly is financial institutions need adult supervision.

Geoffrey Miller: Don't we all.

One question that I wanted to pose to the panel was to ask if anybody had any thoughts about President Obama's two proposals of yesterday, that is basically to prevent banks and bank related financial institutions from engaging in proprietary trading and to put a cap on the market share of non-deposit assets held by financial institutions. Both of those would make huge changes in the banking worlds. Does anybody have any thoughts about that? Rodge, you must, you probably wrote these proposals.

RODGE COHEN: Oh no, believe me.

You know, when you draft a statute there is only one section that is really important to draft: the definitions. That's what you really need to do here. I don't think anybody here, except probably our two professors, can definitively say what proprietary trading is. What is a hedge fund? What are going to be the liabilities which are measured? There is just so much, yet it's the broadest of outlines and the impact on the industry is yet to be determined.

Geoffrey Miller: Annette, do you have some thoughts?

Annette Nazareth: I couldn't agree more. The problem is you really don't know exactly how restrictive this proposed legislation is intended to be. Certainly the rhetoric yesterday was that it's going to be extremely restrictive. If proprietary trad-

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ing involved all manner of taking a principle position, including facilitation trading and that kind of thing, it could be a major issue for trading firms. If it really is intended to only cover that which you intend to purchase to take the risk for yourself, it could be much narrower. But I still think it came as a great surprise. Even in the days leading up to it, I thought what Chairman Volcker had been talking about was going back to having walls between these activities, but permitting these activities in separate legal entities that are not enjoying the benefits of a safety net; not that there would be no entity within your entire corporate family that could be engaged in these activities. It's really at a broad philosophical level, not having seen any of these definitions. It certainly reads as an extremely broad prohibition and a big change in the way some of these firms would have to do business.

Geoffrey Miller: Of course, these days, politically, it's kind of popular to pile on to bankers, so maybe some of that is going on. Brad, do you have any thoughts? I'm sure your clients have deluged you with calls last night after President Obama made his remarks.

Brad Sabel: Well, yes, but it was mainly to vent. On proprietary trading, what the statement says is that they cannot do proprietary trading operations unrelated to serving customers, for their own profit. So it's not saying, "No proprietary trading"—apparently it's no proprietary trading unrelated to your customer business. Now, frankly, I think this is pure Chairman Volcker. Chairman Volcker has always had what some would call old-fashioned views on what commercial banking is. He thought Glass-Steagall was absolutely right. The loosening of Glass-Steagall as a regulatory matter by the Fed happened basically after he wasn't Chairman anymore—so he's always had this view about commercial banking.

About a year ago I heard him talking and he was saying that he now thought that underwriting of securities was appropriate to be connected with a commercial banking business because that's a customer-relationship issue—you make loans to your customers to satisfy that customer, you should underwrite that customer's securities and get them out into the market. He thought that was appropriate for a commercial banking business. I almost fell off my chair. I mean, we never heard that kind of thing when he was at the Fed, but it makes a

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lot of sense. But it does go back to the days of J.P. Morgan, the human being, a hundred plus years ago. This is, you had a relationship with your banker, you went to that banker, you kept your deposits, you got your loans as you needed them, you underwrote securities, and that was all part of the business. Secondary market trading was not really part of that.

Another story about J.P. Morgan—he was the prime underwriter of securities for all the railroad companies. There was some panic in the stock market, and he had to ask his colleagues what time the NYSE closes everyday. He just didn't know—that was secondary market, totally separate from the underwriting business. And I think that this reflects Chairman Volcker—they're not saying "no underwriting" for that reason; they are saying "no proprietary trading, unless related to your customer business." So somehow, if you've had a relationship with a customer, I guess proprietary trading with that customer is okay. Now, how you define that, going back to what Rodge and Annette said, I have no idea. I mean, if you're a trader and someone, out of the blue, calls and says, "I would like to buy and sell securities with you every now and then," the banker says, "Ok, good idea" and signs a little piece of paper and now we're counterparties, are you now a customer? If you are, I think all of this is nonsense. If it's tighter than that, you have to define this.

I've told people in the past, I really wish someone would count up the number of children of lawyers whose educations were financed by Glass-Steagall. The questions raised by that were never ending—lots and lots of energy devoted to figuring out what it means, how to get around it, and, if something like this passes, I see it happening all over again. As lawyers we should be thrilled; I'm not sure it's good for the country.

Geoffrey Miller: Okay, so Jack will have the last word on this topic, and then we'll have a little bit of discussion about Mr. Sabel's provocative remarks.

Jack Coffee: Well, I think we've reached a consensus here, because what everybody's saying up here is the devil is in the details. What is proprietary trading? If I am Citigroup and I am, say, heavily involved in the securitization of real estate-backed securities, I'm basically keeping the housing market alive by trying to bundle up into portfolios subprime home mortgages and securitize them. Socially valuable, but I am ex-

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posing my bank to a great deal of risk in the volatile subprime real estate market. Can I go out and hedge? If I want to hedge, I go out and I purchase an awful lot of credit default swaps. However, does that look like I have just engaged in proprietary trading? Depending on how you define proprietary trading—we're either going to have a very subtle distinction between hedging and speculation, or we're going to be overly prophylactic in not allowing the major banks to be able to engage in what I think is socially desirable hedging. So this all comes down to lots of delicate questions between what is hedging and what is speculation. If you were really to interfere with hedging, I think you're actually increasing the risk-profile of financial institutions.

Geoffrey Miller: Before audience questions, one, addressing Brad's proposal—a modest proposal, perhaps not as modest as Jonathan Swift's proposal that Irish children should be cooked and eaten by the citizens of England, but nearly as modest—that the Fed should be removed from a role in bank supervision. Rodge asked for an opportunity to comment on that, and also Joyce, so Rodge:

Rodgin Cohen: I certainly would agree with Brad—there are many arguments on each side. But there is one argument that I think has not been voiced, which I believe strongly favors the Fed retaining substantial supervisory and regulatory authority, and I will confess I come out on the side of the Fed retaining it. That deals with the following issue: there has been tremendous debate among economists as to whether you can use monetary policy to puncture asset bubbles—some say yes, some say no, but everybody agrees it's a terribly blunt instrument. You can, however, use regulatory authority to puncture assets bubbles, and once you think, "had the Fed been more aggressive, for example, in raising margin rates in connection with the internet bubble, or in connection with the real estate bubble, imposing higher down payment requirements, higher loan-to-value requirements, eliminating no-document loans, or saying, CDO's, CDO's squared, CDO's cubed—maybe they're triple A rated, but these are totally untested instruments, so instead of 100% risk weighting, we're going to weight them at 150% until we have some experience. Had those actions been taken, maybe we would not have had the crisis which occurred. The inclination to strip away that

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power from the agency which has monetary policy as its purview, I think, would be a major mistake.

Geoffrey Miller: Joyce I am sure you completely agreed with Brad's proposal.

Joyce Hansen: Well first of all I would just like to recommend two documents which addressed this issue. One is a speech that the President of the Fed, Bill Dudley, gave this Wednesday. It's on the home page of our website and it got a fair amount of press coverage which I think takes on this question in a very thorough and articulate way.

The second document is also a document which is on the Fed Board's website. It's a letter which Chairman Bernanke prepared and sent to Congress on the role of the Fed on supervision. I'm not going to get into who does what—there are various ways you could structure a regulatory system and the authority of various agencies. Currently the Fed regulates and supervises member banks and bank holding companies and there are various ways you can cut up the regulatory pie. I think to take the Fed out of supervision entirely is just really imprudent and folly.

I heard Brad say two things which I just don't think there is evidence of. One is that we are somehow subject to political influence through our supervisory authority and that somehow impacts our effectiveness in monetary policy. Maybe I have that wrong, but I really don't think there is evidence of that at all, and so that's responding to a criticism which I don't think there is evidence for.

But then there is the question of the case for the Fed's role in supervision? I think there are arguments that can be made for the relationship between execution of monetary policy and the role in supervision, which I think our President has done much better than I can. I tend to focus on the role of a central bank as a financial stability force, and the role which is thrust upon a central bank when there is a financial crisis, and I don't think that the Fed or any central bank can respond as effectively as the Fed has, with not only deep knowledge of markets, which we do have through our activities, but also, with on the ground interaction with bankers and understanding of their business and what's going on. The arrangement may be different in different markets and different jurisdictions and different nations, but I think our markets are such

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that our role in financial stability, whether its in a statute or not, mandates that we have the kind of touch and feel that you get from being involved in supervision. So you can decide the role of the Fed in supervision may be narrower or broader than it is today, and there are arguments that we would make for making it broader, but to say that the Fed should have no role is a very difficult case to make if you look at experience. And our view has been articulated by other commenters, if you look at the UK where the Bank of England did not have a role in supervision, and it is consolidated in UKFSA, that they were much less nimble and much less able to respond to the financial crisis in that market, and when Northern Rock went down, were really not as effective as they could have been, which made the situation much worse than it was.

Geoffrey Miller: I want to give Brad the opportunity to issue a rebuttal.

Brad Sabel: Thank you. I feel beat up here. Just a couple of things. First of all, in terms of the Fed's performance in this crisis, having to do what a central bank does, I think it has performed magnificently. I think the facilities that they set up, the actions they took, Bear Stearns, all the rest, they did exactly what a central bank is supposed to do. Since the 19th Century, I think Walter Bagehot was the one who said the job of a central bank, in a panic, is to flood the street with money at a penalty interest rate. So after everybody sees there is going to be gobs of liquidity, don't worry about getting liquidity but you are going to have to pay up for it. Then they start to relax, then they start to see the cost, then they start to get away from using central bank money, and then things go back to normal. That is kind of what we are in now. We have a lot of different facilities pointed a lot of different ways, at a lot of different markets. All, I think, very well designed—that really makes me proud to be a Federal Reserve alumnus. Do they need supervisory authority to have acted that way? I'm sorry, I still just don't buy it. I think, like I said before, they get reports from other regulators, they put it together, and when you look at it the Fed, you know the Fed's authority over the banking system—forget bank holding companies where they regulate everyone, but just banks themselves—is pretty narrow. There are not that many state member banks now. Bank of New York is now the biggest state member bank in the coun-

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try. They have foreign banks, which is a big deal, but they're foreign banks; they are not the U.S. banks. The extent to actually go in and see the plumbing of banking is actually quite limited. Where they get their exposure is because they are the central bank—people come in and talk to them, they are in the markets every day, they need to know how the repo market works and you can do that without the responsibility of having supervision. So they can go talk to people, they can keep themselves educated, and I think, in fact, something like a council as the Frank bill would have it, a systemic risk council makes an awful lot of sense. That is the perfect mechanism to have that kind of communication going on, and it would give the Fed some serious insulation from political meddling in their monetary policy authority.

Remember, the Fed is a creation of Congress, if Congress wants to abolish the Fed, Congress can do that. The reason we have independence in large part, is historical, it's a part of tradition. Also, the Fed is not an appropriated agency—the SEC, other agencies have a budget; every year they have to go to Congress, every year Congress gets to say what you can and cannot do, because if they don't want you to do something they don't appropriate money for you to do it. The Fed is not appropriated. They have the reserves of the banks, they invest that in securities, they get interest from those securities, they pay for their operations from that interest, and anything left over goes back to the treasury. That is a great part of their independence, that can be taken away, and I really don't want to see that happen. I think taking them out of supervision will go some way, not the whole way, but some of the way to protecting them.

Geoffrey Miller: Okay. Now we have some time for questions from the audience.

AUDIENCE QUESTION: This is a response to Professor Coffee's very interesting survey of the shareholder influence on risky behavior. I'd like to know, first of all, what kind of shareholder are you talking about? Are you talking about Warren Buffett making a phone call, are you talking about institutional investors, or are you talking about day traders, or activist shareholders? And the second part of this question is, how do you measure the shareholder influence? Is there any danger of it being a tautology, or a correlation rather than causa-

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tion—for example, does the CEO court the shareholders or do the shareholders pressure the CEO?

Jack Coffee: Well, I was referring to research undertaken by Rene Stulz. What he did was take rankings prepared by RiskMetrics of corporate governance in terms of what were the most "shareholder friendly" financial institutions, from bottom to top. Those who had the highest ranking on RiskMetrics shareholder friendly governance scale had the worst stock market experience between 2007 and the end of 2008. Those that had the worst rankings on RiskMetrics had a much more mitigated fall, and one inference you can draw from this is the more you're able to resist shareholder pressure, because you were better insulated by your corporate governance, the less that you were likely to take on excessive risk. He wasn't talking about the specific influence of activist shareholders, but I think activist shareholders, in this context, may do harm as well as good. I'm all for activist shareholders if they're going after Amalgamated Widget, but if Amalgamated Widget fails, no one is going to bail them out, and it's different with banks.

AUDIENCE QUESTION: I've been a sole practitioner for 40 years in real estate, and it has always been my belief that mortgages are given based on the value of the property and the ability to borrow and pay, and about 8 or 10 years ago, I started going to closings where banks were giving more than 100% of the value of the property on basic mortgages and equity second loans. And my question is, what happened to the supervision of that? That's where the housing bubble started to develop—when people could borrow more than the value of the property. Where's the regulation, who's responsible, who slipped up?

Geoffrey Miller: Rodgin mentioned that he thought that maybe one way that the bubble could have been addressed is through regulation, through for example, limiting no-doc or low-doc loans, or having tightened underwriting standards. But maybe we could ask anyone on the panel, is it not true that bank regulators were asleep at the switch when underwriting standards both for residential and commercial real estate lending completely fell apart during the decade of the 2000s, and what should be done about that?

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Annette Nazareth: Well, certainly, in hindsight, much more should have been done, and I suspect that in the case of the FED, first of all they were not the regulator of many of these banks that issued the mortgages (certainly not all), and we had no effective regulation of mortgage brokers who were, in the first instances, proliferating a lot of these practices. But, there is no question that one of the lessons learned from this crisis is that this kind of oversight, which in this case has a very strong consumer element to it, is equally important with the other types of risk management that supervisors impose on regulated entities. I suspect that in the early days this was viewed as something that was a developing problem, but not a major problem. And I think what was not fully comprehended was the impact that securitization was going to have on this issue. Something that looked like a relatively small consumer issue that at some point would be addressed became a major financial market issue because of the Kerosene on the fire, essentially, that was being perpetrated by the securitization market which permitted the banks to offload the stuff, securitize, sell it off, and issue more of these loans. So it became a much bigger problem than I think anyone realized, and it happened much more quickly than anybody expected.

Jack Coffee: You have to add one element to this. Everything you said was correct Annette, but why did we have lax lending by loan originators? Because they found that anything they lent, even though it was a liar's loan, or a NINJA loan—a NINJA loan is no income, no assets, no job—all of those could be bundled up, put into a portfolio, and sold to investment bankers who could securitize it because investment bankers, in turn, had found that they could sell these instruments to a global market based on investment grade credit ratings. So we look at how this process fails. Everyone relied excessively on credit ratings, and the credit ratings were done by a gatekeeper who itself didn't really verify the information. It just assumed the facts it was given, gave an investment grade rating, and the market bought it based on those ratings. Everyone pushed it to the next person—in the language of law and economics this is classic moral hazard. I can rationally ignore the credit worthiness of a borrower if, and only if, I am not going to bear the risk of his default. If I know that I will sell this loan within a day to an investment bank and if the invest-

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ment bank knows that within two months it will sell a loan portfolio containing this loan to a world wide market based on investment grade ratings, this condition is met for both the loan originator and the investment bank. And everyone assumes that someone else was doing the job of being the monitor, but securitization did lead to lax monitoring. That, I think, has to be addressed still, in what Congress is doing.

Rodge Cohen: Could I just quickly add: I think the criticism of the supervisors here is less that they were asleep at the switch, than that they just weren't brave enough. Let me explain what I mean. The regulators actually figured this out. In the mid part of the last decade, they proposed limits on commercial real estate lending, they proposed limits on residential mortgages, and they were deluged perhaps less by the banks than by Congress, saying you can't possibly do this. They backed off from what could have been stringent regulation, so there's a lot of blame to go around.

Geoffrey Miller: None of it, however, assumed by anyone on this panel here. Do we have anybody over there?

AUDIENCE QUESTION: With respect to either the products that are traded or the organizations that trade them, do you believe that there is anything that can or should be done with respect to credit rating agencies that can have a positive impact in the future?

Jack Coffee: I have to tell you that yesterday, I published a long column on this in the New York Law Journal which dispositively answered all these concerns, but obviously, there is room for a great deal of debate. Liability is one force—no credit rating agency has ever been successfully sued. The accountants are also gate keepers. They get sued; as a result, they count the beans. I don't know if credit rating agencies have the same exposure, and it was very easy to defer to your client. Once upon a time credit rating agents were fairly safe because no one client accounted for 1% of their business. But with the growth of securitization, they found that they were really dependent on about six, seven, or eight large underwriters. Those underwriters had real market power, and they pressured the rating agencies, in my judgment, to acquiesce excessively because of this unique combination of market power over them coupled with their own freedom from liability.

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So I think there is a lot that Congress could do. Congress has all kinds of provisions and pending legislation, but I think we have to reintroduce due diligence and verification into the process. Liability is at least one of the ways of doing that, although frankly you can only impose so much liability. I'm not for trying to put higher liability on bank directors, or great liability on credit rating agencies, because we're talking about trillions of dollars, and none of these agencies could withstand even a billion dollars of liability. I think we have to focus on using liability as a deterrent, possibly with things like ceilings as to the amount that you should be held liable for.

AUDIENCE QUESTION: Professor Coffee, you mentioned four villains and I was wondering what you thought about a fifth villain which would be too much government intervention in the free market. There are sort of three aspects of that: too big to fail starting with long-term capital management bailout under Clinton/Greenspan, combined with no free market in setting interest rates by Alan Greenspan in fact giving nearly free money to the big financial institutions who wanted to do something with it, and what Mr. Cohen mentioned relating to that point on the interference in the housing market by Freddie Mac/Fannie Mae, various other laws promoting a specific market to be promoted no matter what the market realities were.

Geoffrey Miller: So Jack you got the chance to plug your article in the last question but I don't think you have an article proposing a free market solution to the financial crisis—or is that coming?

Jack Coffee: I think we should ask the whole panel what they think about your approach, I'm not a Republican, but I'm someone who believes that Secretary Paulson and Chairman Bernanke really saved the country by quick intervention last year. I do think along the lines you went that there is a plausible case, maybe a good case, that there was too much free money created by Chairman Greenspan at an earlier point. Bubbles do have something to do with money being a little too loose, that's one of a number of things you can point to. But I think the danger of too much government here pales against the danger that the important governmental officials would have deferred taking action and done nothing. That hap-

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pened in 1929 and we saw the consequences of doing nothing at a moment of a critical panic.

Brad Sabel: I agree if the Fed had not taken the actions it took we would probably be living in caves right now. I think they really did save us. Once the crisis started, yes there was a ton of government involvement but I think we had no choice. Before then, you always try to get a mix, you want the private sector to work but, especially with banks, you want them to operate within bounds. You can debate who did what right and who did what wrong. Frankly, the economists are still talking about what caused the Great Depression, and this is 75 years ago. They're going to continue to talk about this for decades more, and of course no one is going to really know exactly what the problem was. I personally think that before this, Fannie and Freddie were mistakes. There were too many political interests in favor of that, once the mortgage market started getting up, they should have been phased out but for a variety of reasons they weren't. Beyond that, I don't know that any less regulation would have really made things better; if anything it probably would have made things worse.

Geoffrey Miller: Since we're almost out of time, I'm going to offer anyone on the panel the opportunity to comment on anything we've discussed during this session.

Annette Nazareth: I would say one thing. Harkening back to Professor Coffee's statement about how regulation moves in sine curves and it relates to the question about whether we have too much regulation or not enough regulation. It is really difficult to hit that regulatory sweet spot and I think that's going to be a real challenge in the next several months as there is a lot of focus on regulatory reform. Clearly we need to make regulation better. It needs to be modernized, it needs to address a number of issues that came to the fore in the last crisis. The real challenge is going to be not to undershoot or dramatically overshoot, and that is something that I think as citizens we should all be very conscious of and follow this very closely.

Geoffrey Miller: Rodge?

Rodge Cohen: A quick comment on the issue of "too big to fail." I believe that a number of the legislative proposals, including the proposals from the administration of yesterday

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represent to a large extent a frustration with an inability to deal with the too big to fail issue. For example, instead of too big to fail we say just too big. This is, in my view, the lynchpin of regulatory reform. I think it is possible to get too big to fail right, which means ending it without creating either loss to the taxpayer or systemic consequences of great severity but that should really be the focus.

Joyce Hansen: I would just say that I agree with the comments of Annette and Rodgin and I hope that we are not losing the momentum to address the issues that are clearly before us. I think if we don't move forward on some sort of regulatory reform bill, there are many greater negative consequences that could come to visit us in future years, so I hope we really regain the momentum on that.

Geoffrey Miller: I want to thank our fantastic panel and also those of you who asked questions from the audience. Please join me in thanking this wonderful group.

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