THE FINANCIAL CRISIS ONE YEAR LATER: PROCEEDINGS OF A PANEL DISCUSSION ON LESSONS OF THE FINANCIAL CRISIS AND IMPLICATIONS FOR REGULATORY REFORM

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This Article consists of an introductory essay and an edited transcript of an unusual panel discussion on implications of the financial crisis. A panel of experts composed of prominent corporate and banking law scholars, local financial industry executives, and a bank regulator convened at a recent symposium held at the Creighton University School of Law and engaged in a moderated discussion on applying lessons from the first year of the financial crisis to basic considerations underlying financial regulatory reform.

There was a surprising degree of agreement on a number of basic issues between the "pro-regulation" academics and the "pro-market" business executives. In particular, both groups consistently cited the importance of the structure of financial incentives and the necessity of aligning such incentives with organizational goals as both an important cause of, and potential solution to, the financial crisis.

The panel discussion covered six broad topics: (1) causes of the financial crisis, (2) government bailouts and market support, (3) historical analogies and lessons, (4) foreign banks and globalization, (5) systemic risk and its regulation, and (6) consumer issues and executive compensation. In each of these areas, the differing perspectives and experiences of the participants and the interaction among them resulted in thought-provoking discussion on fundamental issues of financial system reform.

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This panel discussion was conducted as part of a conference "Lessons of the Financial Crisis: Implications for Regulatory Reform," which was held at the Creighton University School of Law on September 25, 2009. For materials on the conference and a podcast of the panel discussion on Creighton Law School's website, see http://www.creighton.edu/law/news/conferencessymposia/index.php. The proceedings of the panel have been edited for length and clarity. I gratefully acknowledge the generous time and effort of the panel members and the administrative and financial support of Creighton law school for the conference.

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I. INTRODUCTION

One year after the fall of Lehman Brothers marks a convenient dividing line in our government's response to the worst financial and economic crisis since the Great Depression of the 1930s. We have completed Phase I—stabilization of the financial system—and are gearing up for Phase II—reform of the financial system's regulatory structure. The crisis invoked unprecedented governmental responses to stabilize the financial system and prompted a far-reaching rethinking of assumptions which were widely accepted over the past two decades concerning the roles of markets and regulation. The outcome of the debate concerning the appropriate extent and form of government regulation will strongly affect the nature and extent of financial system reform measures that are eventually enacted. This introductory essay and the proceedings of the panel discussion which follow explore lessons of the financial crisis and implications for regulatory reform from a variety of perspectives.

Causes. Causes of the crisis remain relevant since they will help in defining solutions. Two well-known and important causes of the financial panic and economic crisis were twin bubbles in credit and housing. The easy availability of cheap credit through low interest rates and the seemingly ever-increasing economic success and rise in housing prices during the period from 2004-2007 resulted in aggres-

sive overleveraging by both corporations and individuals.[1] Such leverage is a two-edged sword, and both corporations and households are now going through the painful process of deleveraging, which itself is an important reason for the lingering effects of the crisis.

The most highly debated cause of the crisis is the extent to which regulatory inadequacies played a role. Beginning in the 1990s, and particularly during this decade, new financial markets developed rapidly. Sometimes popularly referred to as the "shadow banking system," the main components were asset securitization and derivatives. Both of these markets expanded significantly to include securitization of subprime mortgages and a burgeoning volume of credit default swaps. The Gramm-Leach-Bliley Act of 1999[2] and the Commodity Futures Modernization Act of 2000[3] removed barriers between activities of commercial banks and investment banks, and also ensured that over-the-counter swaps would remain largely unregulated.[4] It was believed that this financial innovation would lower overall risk by spreading risk throughout the financial system.[5] However, at the same time it had the perverse effect of concentrating risk in the limited number of financial institutions with the size, strength and expertise to act as dealers of financial products in these new markets.

Another difficult aspect of the crisis is its global reach. Our credit and housing bubbles grew so large partly because large purchases of United States Treasuries at relatively low interest rates by the central banks of China and Japan enabled America as a whole to keep spending beyond its means. The emergence of global financial markets and institutions also made it more difficult to respond to the crisis. As a result, the Federal Reserve ("Fed") has, for the first time, included foreign commercial banks and central banks in its efforts to stabilize the financial system.[6]

1. Martin Neil Baily, Robert E. Litan, & Matthew S. Johnson, The Origins of the Financial Crisis 7 (Nov. 2008), available at http://www.brookings.edu/~/media/Files/rc/papers/2008/11_origins_crisis_baily_litan/11_origins_crisis_baily_litan.pdf.

2. Pub. L. No. 106-102, 113 Stat. 1338 (1999).

3. Pub. L. No. 106-554, § 1(a)(5), 114 Stat. 2763, 2763A-365 (codified in scattered sections of 7, 11, 12, and 15 U.S.C.).

4. Gramm-Leach-Bliley Act 15 U.S.C. §§ 6801-6809 (2006); Commodity Futures Modernization Act, Pub. L. 106-554, 114 Stat. 2763 (2000).

5. See, e.g., Alan Greenspan, Chairman, Fed. Reserve, Corporate Governance, Remarks at the 2003 Conference on Bank Structure and Competition (May 8, 2003), available at http://www.federalreserve.gov/boarddocs/speeches/2003/20030508/default.htm. Well-known investor Warren Buffett was a notable dissenter to this widespread view. Based on his difficult experience in liquidating the derivatives portfolio of General Reinsurance, a company acquired by Berkshire Hathaway, he famously referred to derivatives as "time bombs." See Berkshire-Hathaway, Inc., 2002 Annual Report 13 (2003),

6. Ben S. Bernanke, Chairman, Fed. Reserve Speech at the Council on Foreign Relations, Washington, D.C. (March 10, 2009), available at http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm.

Any panic or crisis also involves a loss of confidence by investors and the public which can act as an important additional factor. A striking contrast between the bursting of the technology bubble in 2000-2002 and the current crisis is that at the beginning of this decade Alan Greenspan had the reputation and credibility to calm markets almost immediately. In 2008 there was no such person or institution on the scene. In fact, in 2008 Greenspan's hands-off policies on markets appeared to be a major contributing factor to the crisis and there was no one in the Federal Reserve ("Fed"), the Bush Administration, or Congress with the stature or policies to calm roiled markets.

Phase I—The Government's Response to Stabilize Financial Markets. Throughout the period of the run-up to the crisis, from the summer of 2007 to September 2008, financial commentators, the press, and the government continually underestimated the scope and severity of financial system problems. The government's initial reaction to serious problems at major financial institutions was both ad hoc and ambivalent, as the response of the Fed and the Bush Administration's Treasury Department vacillated between doing what was necessary in times of crisis and adhering to a free market philosophy.[7]

Matters came to a head in September 2008 as the government oversaw the sale of Merrill Lynch to Bank of America, but let Lehman Brothers fail. The result was a full-blown financial crisis. Three-month Treasury bills essentially yielded zero, as panicked investors accepted no return for a safe place to park their money. Markets froze, banks became reluctant to lend to each other in the interbank market, and risky assets could only be sold at fire-sale prices. The failure to rescue Lehman Brothers was seen as a huge mistake, especially in Europe and Japan where the "Lehman shock" was credited as causing a global financial crisis which was "made in America."[8] One result of the strong market reaction was the government's rescue of the giant insurer AIG, whose subsidiary was the largest provider of protection in the credit default swap market.

One immediate consequence of the crisis was the end of independent investment banks on Wall Street. This is ironic since the leading investment banking firms on Wall Street may have also been a significant contributing factor in causing the crisis due to their transforma-

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7. *See, e.g.*, Steven M. Davidoff & David T. Zaring, Regulation by Deal: The Government's Response to the Financial Crisis, 61 ADMIN. L. REV. 463 (2009).

8. Ben S. Bernanke, Chairman, Fed. Reserve, Speech at the Economic Club of New York (Oct. 15, 2008), available at http://www.federalreserve.gov/newsevents/speech/bernanke20081015a.htm [hereinafter Bernanke Speech at the Economic Club].

tion from private partnerships to public corporations.[9] With public shareholders now providing their permanent capital, investment bankers may have become more focused on short-term performance and annual bonuses and more willing to assume outsized risks. As credit markets and funding sources froze, the investment banks all became bank holding companies with banking subsidiaries whose savings accounts provided a more stable source of funding. Today no "pure" independent investment bank remains on Wall Street.

Despite some ambivalence about rescuing individual financial institutions, in the fall of 2008 the Fed took two sets of unprecedented steps in an effort to stabilize the entire financial system. First, it encouraged bank borrowing from its discount window. It sought to remove the stigma of the discount window as a place where a "troubled bank" went as a last resort, paying high interest rates and providing bulletproof collateral such as United States Treasuries.[10] Second, and of even greater significance, were numerous Fed (and also Federal Deposit Insurance Corporation ("FDIC")) programs which widely lent to, or guaranteed debts of, corporations in an effort to stabilize entire markets.[11] These included the commercial paper market and asset-backed securities markets. As the Fed began to strain its resources, the Bush Administration decided it was necessary to go to Congress for funds. Thus, the Troubled Asset Relief Program ("TARP") was born.[12]

The two stated goals of the TARP program were to rescue troubled homeowners by refinancing mortgages and to buy bad assets (mortgage-backed securities) from banks and other financial institutions.[13] However, once Congress enacted TARP neither of these goals was attempted. It was too difficult to set accurate prices for purchasing bad assets when markets were not functioning properly. Instead, the Bush Administration utilized the law as a basis for making direct capital injections into financial institutions. The entire banking system was short of the capital it needed to recognize and write down losses. Since this capital could not be raised from the private sector in a time of crisis, the government stepped in as the capital provider of last resort.

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9. See, e.g., Michael Lewis, The End, Portfolio.com, Nov. 11, 2008, http://www.portfolio.com/news-markets/national-news/portfolio/2008/11/11/The-End-of-Wall-Streets-Boom/.

10. *See* Bernanke Speech at the Economic Club, *supra* note 6.

11. For a concise summary of the major Fed programs and the specific support provided to certain large financial institutions, see Board of Governors of the Federal Reserve System, Monetary Policy Report to the Congress 47 (Feb. 24, 2009), available at http://www.federalreserve.gov/monetarypolicy/files/20090224_mprfullreport.pdf

12. Emergency Economic Stabilization Act, 12 U.S.C. § 5201 (2008).

13. *Id.*

Phase II—Financial System Reform. Perhaps the most significant and troubling issue in financial regulatory reform is the regulation of systemic risk. Systemic risk is the idea that some banks are "too big to fail," i.e., that the federal government might rescue large, failing banks to prevent a greater contagion of the banking system, with disastrous spillover effects to the general economy, as occurred during the Great Depression.[14] This policy had never applied to other financial institutions (i.e., nonbanks), such as investment banks or insurance companies, where the spillover risk was not as significant.[15] However, the nature of systemic risk changed from the original Depression fear of depositors withdrawing their savings in a "run on the bank" to more recent concerns about the "interconnectedness" of large financial institutions, including investment banks and even hedge funds, in rapidly expanding markets such as derivatives and asset securitizations. The government's ambivalent and ad hoc response to the financial crisis also had historical precedent, as the government had rescued a number of large banks as being "too big to fail," but had also denied the existence of a policy to do so for fear of "moral hazard," i.e., that banks would feel too assured of rescue and therefore assume too much risk.[16]

For the first time since the 1930s the United States faced a financial crisis which involved true system risk to the financial system. Numerous bailouts of nonbanks (i.e., investment banks and insurance companies) sparked widespread debate concerning the means to regulate systemic risk and prevent any reoccurrence of nonbank bailouts.

One solution, advocated by former Fed Chairman Paul Volcker, was to undo Gramm-Leach-Bliley and once again separate commercial banking activities (which were low risk, highly regulated, and systemically important) from investment activities (which were high risk, lightly regulated, and systemically unimportant).[17] Another proposal

14. For a discussion of systemic risk, see, e.g.,Steven L. Schwarcz, Systemic Risk, 97 Geo. L.J. 193 (2008).

15. The notable exception was the Fed's intervention to arrange for the rescue of Long Term Capital Management, a hedge fund, in 1998. Although the Fed committed no funds, the rescue of a hedge fund remained controversial. This action might be seen as both a departure from usual practice and the growing systemic importance of nonbanks in the financial system. See, e.g., Craig Furfine, The Costs and Benefits of Moral Suasion: Evidence from the Rescue of Long-Term Capital Management (BIS Monetary and Econ. Dep't, Working Paper No. 103, 2001) (arguing that the benefits of the rescue may have been less, and that the costs in terms of moral hazard may have been greater, than was perceived at the time of the rescue), available at http://www.bis.org/publ/work103.pdf?noframes=1.

16. Daniel K. Tarullo, Governor, Fed. Reserve Bd., Speech at the Exchequer Club, Washington, D.C., (Oct. 21, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20091021a.htm.

17. This proposal is associated with the Group of Thirty, which is chaired by former Fed Chairman Volcker. See Group of Thirty, Financial Reform: A Framework for

was to organize a committee of financial regulators that would monitor systemic risk activities of all financial institutions and recommend any necessary actions. The Obama Administration's financial system reform plan[18] calls for the creation of a Financial Services Oversight Council composed of federal financial regulators and chaired by the Treasury Department to coordinate financial regulations generally and for an expansion of the Fed's supervisory authority to enable it to act as the sole regulator of systemic risk for all systemically significant financial institutions which own a bank.[19] Any approach which identifies "systemically significant" financial institutions arouses controversy due to its moral hazard implications—it implies government backing in times of crisis. Such an approach would therefore presumably also require additional regulatory safeguards, such as a higher level of required capital, which would subject nonbank financial institutions to a higher degree of prudential regulation that is typically associated with commercial banks.

Another major theme of reform following the financial crisis is an ongoing re-evaluation throughout Organisation for Economic Co-operation and Development ("OECD") countries of the efficiency of markets and the appropriate relationship between markets and government regulation.[20] There is a widespread view that financial

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Financial Stability (Jan. 15, 2009), available at http://www.group30.org/pubs/reformreport.pdf. Volcker became chairman of the White House's Economic Recovery Advisory Board, although his ideas went farther than, and were described as being "at odds" with, the Obama administration's initial financial regulatory reform plan. See, e.g., Damian Paletta & John R. Emshwiller, Volcker Calls for Restricting Banks' Risk, Trading Activity, Wall. St. J., Sept. 17, 2009, available at http://online.wsj.com/article/SB125313031639216991.html. However in early 2010, the white House embraced this "Volcker Rule." See *infra* note 29.

18. Dep't of Treasury, Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation (2009) available at http://online.wsj.com/public/resources/documents/finregfinal06172009.pdf [hereinafter Treasury]. The Obama administration also backed the creation of a new consumer financial protection agency. See id. at 7. This indicated basic agreement with the idea of a "twin peaks" regulatory model in which prudential regulation and consumer protection are separated. For a discussion of the "twin peaks" approach in the context of the U.S. financial regulatory system, see, e.g., John C. Coffee Jr. & Hillary A. Sale, *Commentary on Redesigning the SEC: Does the Treasury Have a Better Idea?* 95 VA. L. REV. 825 (2009).

19. Treasury, supra note 16; see also Barack Obama, President, Remarks by the President on Financial Rescue and Reform (Sept. 14, 2009), available at http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Financial-Rescue-and-Reform-at-Federal-Hall/. The envisioned role of the Fed as the sole regulator of large, interconnected financial institutions has diminished over time due to criticism of the Fed's performance as a bank supervisor. *See, e.g.*, Edmund L. Andrews, Bernanke, in Nod to Critics, Suggests Board of Regulators, N.Y. TIMES., Oct. 1, 2009, *available at* http://www.nytimes.com/2009/10/02/business/economy/02regulate.html

20. *See* OECD, Policy Framework for Effective and Efficient Financial Regulation: OECD Recommendation and Principles (2009), *available at* http://www.oecd.org/dataoecd/18/53/44187223.pdf; OECD, The Financial Crisis: Reform and Exit Strategies, (2009) available at http://www.oecd.org/dataoecd/55/47/43091457.pdf.

regulators were overly deferential to financial markets during the last two decades. One result is likely to be new regulation in areas such as over-the-counter derivatives, particularly in the credit default swaps market which caused the bailout of AIG.[21] This market was previously left unregulated to promote innovation in financial products and markets.

Part of this debate is the continuing reference to historical examples of the crises of the Great Depression and Japan's "lost decade" of the 1990s. Commentators with different philosophical views on the respective roles of government and private markets draw opposite lessons from government's fiscal and monetary responses to these important past crises. Those who are suspicious of an active government role claim that in both cases government spending did not lead to economic recovery, but merely created large budget deficits. Those in favor of a continuing active government role in times of crisis, including Secretary Treasury Geithner and Fed Chairman Bernanke, claim that government intervention prevented an even greater catastrophe and aided in eventual recovery.[22]

A final basic theme of the response to the financial crisis and financial system reform is the question of "Wall Street versus Main Street." There has been widespread criticism that the government's actions have bailed out the titans of Wall Street but have done little to provide relief to the more severe problems of small businesses and individual consumers on Main Street.[23] Although it may arguably be necessary to first fix the financial system to support a broader economic recovery (which is the assumption underlying policies related to systemic risk), commentators have raised the issue of whether Wall Street's traditional role of raising and allocating capital to support manufacturers and the real economy has given way to a single-minded pursuit of Wall Street profits, or "finance for the sake of finance."[24]

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21. *See, e.g.*, Barack Obama, President, Remarks by the President on Financial Rescue and Reform (Sept. 14, 2009), available at http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Financial-Rescue-and-Reform-at-Federal-Hall/

22. David Stout & Brian Knowlton, Geithner Seeks Broader Powers Over Financial Firms, N.Y. Times, March 24, 2009, available at http://www.nytimes.com/2009/03/25/business/25web-bailout.html?_r=1; see also David Leonhardt, The Big Fix, The N.Y. Times Magazine, Jan. 27, 2009 (quoting Geithner as stating: "The mistake the United States made during the Depression and the Japanese made during the '90s was too much start-stop in their policies"), *available at* http://www.nytimes.com/2009/02/01/magazine/01Economy-t.html?_r=1&scp=1&sq=Timothy%20Geithner%20%22New%20York%20Times%20Magazine%22&st=cse

23. *See, e.g.*, Joseph E. Stiglitz, Freefall: America, Free Markets, And the Sinking of the World Economy (2010).

24. *See* Lawrence E. Mitchell, *Is Financialism Destroying Capitalism? Finance for the Sake of Finance,"* which appears in this issue.

This question of "Wall Street versus Main Street" has also become an important political issue with many facets, including the volatile question of compensation packages for Wall Street executives. The Obama Administration has made some attempt to refocus on, or at least emphasize, aspects of its crisis response which aid consumers and small businesses. When the House Financial Services Committee began to consider financial system reform in October 2009, it first looked at the creation of a new consumer financial protection agency and executive compensation before turning to the question of regulating systemic risk.[25]

Legislative priorities of the Obama administration have also been questioned. Would it have been better to "use" the financial and economic crisis to push for financial regulatory reform rather than health care reform? Or, as occurred following the stock market crash of 1929, is it better to have commissions first conduct thorough investigations of the underlying causes and issues to pave the way for sweeping financial system reform?

Panel Discussion. The complex and controversial issues surrounding the financial crisis were recently discussed by an unusual panel of experts composed of prominent corporate and banking law scholars, local financial industry executives, and a bank regulator. Although the academics and business executives tended to have different philosophical approaches to the importance of deferral to private markets versus governmental regulation, there was a surprising degree of agreement on basic issues.

Perhaps the most significant factor cited consistently by the panelists as both an important cause of, and potential solution to, the financial crisis was the structure of financial incentives and the necessity of aligning such incentives with organizational goals. There was widespread agreement that incentives work: If, like some aggressive mortgage brokers, incentives to officers are based on short-term mortgage loan volume without regard to quality, the result will be a large volume of mortgage loans of low quality. Accordingly, linking incentives to an appropriate long-term risk-return strategy, in addition to short-term financial performance, must play an important role in reforming the financial system and preventing future crises.

The panel discussion covered six broad topics: (1) causes of the financial crisis, (2) government bailouts and market support, (3) historical analogies and lessons, (4) foreign banks and globalization, (5) systemic risk and its regulation, and (6) consumer issues and execu-

25. *See* Barack Obama, Remarks by the President on Financial Rescue and Reform (Sept. 14, 2009), *available at* http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Financial-Rescue-and-Reform-at-Federal-Hall/.

tive compensation. In each of these areas, the differing perspectives and experiences of the panelists and the interaction among them resulted in thought-provoking discussions which covered many facets of important issues.

In addition to the twin bubbles in credit and housing, the panelists cited a number of other significant causes of the financial crisis: leverage, banks' overreliance on stochastic modeling, incentives for short-term profits over long-term goals, global imbalances, and the rapid growth in derivatives markets. The liveliest discussion focused on regulatory issues. A number of panelists pointed to problems with substantive law, including the blurring of commercial and investment banking activities under the Gramm-Leach-Bliley Act of 1999[26] and the foreclosing of the regulation of derivatives under the Commodity Futures Modernization Act of 2000.[27] Others held the view that the major problem was not a regulatory gap, but rather the failure of regulators to exercise authority and undertake enforcement of existing laws.

Government bailouts and market support was the topic which commanded the lengthiest discussion. A number of panelists remarked that the government bailouts of deeply insolvent financial institutions went beyond the classic lender-of-last-resort practice under which bank regulators lent funds under tough loan terms to healthy banks that encountered short-term liquidity problems. Although this historical practice consisted of occasional examples rather than clear rules, equity investments in deeply insolvent financial institutions arguably constituted a new form of government support. However, one panelist dismissed overseas claims that the United States government's failure to rescue Lehman Brothers was a mistake that triggered a global financial crisis; it was inevitable that a large financial institution would fail given the widespread insolvencies among such institutions.

With respect to the necessity and desirability of the unprecedented Fed market support programs, the panelists split along unusual lines. The "pro-market" business executives thought that the Fed programs were generally necessary to have the capital markets resume their normal functions, while the "pro-regulation" academics questioned the necessity of bailouts and demonstrated a stronger confidence in the ability of markets to recreate themselves. All the panelists agreed that the merits of individual market support programs differed substantially; one panelist cited the Fed's guarantee of money

26. Pub. L. No. 106-102, 113 Stat. 1338 (1999).
27. Pub. L. No. 106-554, § 1(a)(5), 114 Stat. 2763, 2763A-365 (codified in scattered sections of 7, 11, 12, and 15 U.S.C.).

market funds as an important and cost-free success. Another panelist noted that market failures have both widespread and local market impacts, with, for example, Nebraska losing a large majority of its consumer finance companies due to a lack of capital market funding sources such as asset securitizations.

There was a lively discussion about whether the Obama Administration's response to the financial crisis represented continuity or change compared to the Bush Administration's policies. A number of panelists noted some changes, including a shift in emphasis from macroeconomic issues, such as markets and systemic risk, to consumer issues. One panelist attributed the change, in part, to the longer time frame available to the Obama Administration and its early emphasis on other legislative priorities, notably health care reform. On the other hand, another panelist pointed to Obama's reappointment of Fed Chairman Bernanke and elevation of Treasury Secretary Geithner as evidence of fundamental continuity with Bush's policies.

Both Bernanke and Geithner seemed to take the same lesson from different historical analogies. This common lesson, derived from their respective backgrounds as a student of the Great Depression and as an attaché at the United States's embassy in Tokyo, was "don't stop fiscal and monetary stimulus too soon." One panelist agreed with this lesson, noting that Franklin Delano Roosevelt's biggest mistake was prematurely addressing budget deficits in 1937, which prolonged the Depression, and wondering if, despite their "lesson," the Obama Administration would ultimately do the same.

Another panelist found it ironic that Treasury Secretary Geithner seemed to be repeating, rather than learning from, the Japanese experience, i.e., that strong stimulus must be utilized effectively in conjunction with reforms to ensure that government spending is used wisely rather than for "roads to nowhere" and that banks must recognize losses and clear bad loans from their balance sheets. This remark produced a chorus of agreement from financial industry executives and our regulator on the necessity of banks dealing aggressively with bad loans rather than delaying action in the hope that a rising economic tide would eventually lift all boats.

Panelists agreed that the financial crisis highlighted the new importance of the Fed's global role. The Fed's swap lines to other central banks have made it, in a sense, the central bank for the world. However, to a large extent this is due to the dollar's status as the global reserve currency and the resulting need for dollars in a financial crisis. The Fed's actions nevertheless represent a major change from a

decade ago when the Fed seemed reluctant to support dollar-denominated assets of foreign banks.

Panelists expressed some skepticism about the proposed new role of the Fed as the systemic risk regulator under the financial regulatory reform plan of the Obama Administration. One panelist noted that, although the Fed was the natural place to look for a systemic risk regulator, adding the more political role of systemic risk to the Fed's current goals of price stability and unemployment created a potential risk to the Fed's independence. Another panelist noted that the Fed was a poor choice since the Fed's culture is dominated by economists who are trained to believe in efficient markets and not in systemic risk, and that bank supervision has historically been a lower priority than monetary policy. Finally, a panelist noted that there were substantial objections to the Fed acting as the sole systemic risk regulator as opposed to a coordinating committee of regulators fulfilling that role.

Consumer issues have recently assumed a more prominent position with respect to the financial crisis amidst accusations that government policy is aiding Wall Street rather than Main Street. A panelist noted that this question raises a fundamental issue concerning systemic risk, i.e., the validity of the assumption that it is first necessary to stabilize the functioning of the financial system to support the economy and, ultimately, to help individuals.

All of the panelists agreed that executive compensation was an important issue and not merely a populist diversion. In fact, a number stated that it was at the heart of the problem. Rather than the amounts of executive compensation which has dominated the news, panelists focused on the importance of structuring incentives, since incentives work and their structure will strongly influence risk-taking and the long-term strength of the financial system. The two business panelists looked to a corporation's board of directors to be responsible for achieving an appropriate balance between short-term goals and long-term goals.

All of these topics—and more—are covered as the panelists discuss the implications of the financial crisis.

II. PROCEEDINGS OF THE PANEL, SEPTMEBER 25, 2009

Moderator: *Bruce Aronson*

Panelists:

- *William K. Black*, Professor of Law, University of Missouri –Kansas City

- *Lawrence E. Mitchell*, Professor of Law, George Washington University
- *John Munn*, Director, Nebraska Department of Banking & Finance
- *Heidi Schooner*, Professor of Law, Catholic University of America
- *E.C. "Cris" Stone*, Chief Credit Officer, First National of Nebraska
- *Rick Witt*, Chief Investment Officer, Mutual of Omaha

III. CAUSES OF THE FINANCIAL CRISIS

PROFESSOR ARONSON:

To begin I would like to discuss briefly what the panelists think about the causes of the financial crisis of 2008. We want to focus more on the implications and solutions rather than on the causes, but how you identify the causes can have a significant impact on proposed solutions. There are many causes that have been proposed, such as credit bubbles, housing bubbles, regulatory gaps or mistakes, and loss of confidence. I would like to ask the panelists if there is anything of particular importance that they wish to identify.

And as an adjunct to that question, it has been a year since the rescue of Lehman Brothers, which many people mark as the beginning of the true crisis. I am also curious to know if people's view of the important causes of the crisis has changed at all during this past year as events have unfolded.

MR. WITT:

I felt on day one and I still feel today one of the fundamental issues driving the crisis was leverage. And that was driven in large part by people's desire for returns on capital.

Go back and look at Lehman Brothers' balance sheet on June 30, 2008. You have a company with $750 billion of assets, one line item on the asset side, financial instruments and other, $250 billion, and you have capital of $27 billion. And you go into the footnotes, they are four pages long, and read the description of financial instruments and other, I challenge you to figure out what in the world they were talking about. So certainly one of the issues there, in my opinion, was leverage.

And another issue in my opinion is certainly that you need to be very careful about overreliance on stochastic modeling. Models are interesting, but there are a lot of Ph.D.'s walking around on Wall Street that will tell you that in the Black Swan event their model did not work and they are looking for work.

MR. STONE:

Just to follow up on leverage, Bear Stearns at quarter end reporting dates was showing thirty to one. They were getting down to thirty to one, since they were hitting fifty to one during the quarter. We have a pretty senior bank regulator sitting here, and he will probably tell you that ten to one in the banking industry has been kind of a rough rule of thumb, give or take, depending on where you are in the cycle.

I do not want to give simplistic answers to very complicated problems, but I will make a couple of general observations. Historically, commercial banks get in trouble when they get short-term—putting short-term profit or growth goals ahead of long-term soundness goals. Incentives are like gravity. They work, and you need to be really careful what you incentivize. The commercial banking industry for many years did not have a lot of incentives. They really came into vogue over the last couple of decades. And they work. And if you do not structure them right – they are not all bad - they can incentivize the wrong behavior if you reward short-term profitability and growth ahead of long-term soundness.

PROFESSOR MITCHELL:

Leverage is the desire for the return on capital. That is actually critical, but I want to give a little bit broader historical context. While this happened in the banking industry over the last decade, it has also been a feature of our capital markets for at least the past ten years, and has produced an enormous focus on short-term behavior in the real economy just as it did in the financial economy. Again, this is because of the way incentives were structured.

I will just say one quick thing on anticipating fixes, but I think the stupidest piece of economic legislation ever to be passed in the United States was the Gramm-Leach-Bliley Act which eliminated the Glass-Steagall Act's prohibition on national banks engaging in the securities business. The Glass-Steagall Act was passed in 1933. Carter Glass had been in Congress in one form or another or Treasury Secretary for about thirty years and lived through a lot before that statute was passed. They knew and understood that the reason they had a huge depression based on a credit crisis following the stock market crash was because the banks had made huge margin loans to brokers and the collateral became worthless - sounds familiar - and because the banks themselves used the credit supply of the United States to speculate in securities. Somehow in 1999 we decided that we were smarter than they were and that the economic laws had changed so there would be no risk—the market would take care of it. So we began

to allow banks who are charged with the extraordinary responsibility of maintaining our credit and money supplies to go ahead and speculate. And that is what they did.

MR. MUNN:

I also would hearken back to what happened in 1999 as kind of the beginning point. Six or seven years later when it became necessary to deal with some of these organizations, regulators, both federal and state, were not going to do so. You can get three or four people in a room deciding what you are going to do with Bear Stearns or what you are not going to do with Lehman Brothers. And I would hope that an outcome of what is what going to happen in Congress will be to find a way to deal with something that did not look like a bank ten or fifteen years ago but acts like one now.

PROFESSOR SCHOONER:

I think related to leverage are global imbalances in terms of savings versus lending which was also a cause. Our housing policy is part of the picture as well, with Fannie and Freddie and our belief that owning a home is a wonderful thing that we must encourage. I do not think we can forget that.

In terms of how I have changed my view in the last year, or maybe how it has subtly shifted, I would say that at first I was not convinced that there really was a problem with regulations so much as a failure to enforce the regulations that exist. And I still believe that. And that is a particular interest for me: How much of the regulatory failure is due to the lack of regulation and how much to the unwillingness to enforce? I also think that international competition plays in the crisis as well. One of the things that the industry is constantly bringing up is that if you regulate us, we will suffer internationally. Internationally we want to have a level playing field, and I think some of that plays into the lead-up to the crisis.

I also want to comment on Gramm-Leach-Bliley. I am not convinced that allowing banks to engage in the securities business per se was a cause, but I do believe that to the extent that Gramm-Leach-Bliley allowed financial institutions to grow very large and, therefore, increase in complexity, it was definitely a factor. But I am not sure it is the combination of businesses so much as the size and complexity that are the issue.

PROFESSOR BLACK:

One of the major differences in the economy now is the role of derivatives. And I think an even dumber law (than Gramm-Leach-Bliley) was the law that was passed the next year. Brooksley Borne, the head of the Commodities Future Trading Commission ("CFTC"), attempted to regulate financial derivatives in a bipartisan coalition including the Clinton Administration, Phil Gramm, and others. Alan Greenspan killed that with legislation that said not only can you not go forward with this particular regulation, but on top of that we are going to remove your statutory authority to go forward with virtually any regulation of derivatives. And derivatives became such a massive market and so opaque that they are a major part of the story of why we have systemic risk. And systemic risk simply means the whole system potentially comes down, typically in a liquidity crisis.

Let me mention briefly my background. I have a dual appointment in law and economics. I am a white collar criminologist and a former financial regulator.

How many people remember the subprime crises of 1991 and 1992? It is a trick question because one did not exist. Conditions were leading up to a crisis but we stopped it by regulation. But the same kind of insane practices were occurring. So what happened to regulation during the current crisis? This is largely a story of nonregulation as opposed to deregulation. Eighty percent of the nonprime loans were made by entities that are not federally or state insured and are essentially unregulated. The Federal Reserve ("Fed") had power under, a weird acronym, HOEPA ("Home Ownership and Equity Protection Act of 1994") to regulate them but Greenspan refused to do so. So the great bulk of the story is an unregulated sector making loans.

What happens in the regulated sector? Well, look at the Federal Deposit Insurance Corporation ("FDIC"). It loses more than three-quarters of its personnel. It goes to something called MERIT examination, which is an oxymoron, which said basically if it was a highly rated institution - and they were all highly rated as a statistical statement during that period - you do not bother to look at loan files. Well, if you do not look at loan files you get all kinds of disasters coming. So FDIC's effectiveness was destroyed—beginning certainly in the Clinton Administration but mostly in the Bush Administration.

What happens to the Office of Thrift Supervision, which becomes the most infamous of the federal regulatory players? Well, its director comes to a press conference, standing next to the three leading banking lobbyists in America, and he comes with a chain saw. And they have pruning shears. And they are posed over the pile of federal regulations. And the idea is to show that they are going to cut through all

federal regulation. Well, they succeeded. You get a disaster in those circumstances.

The Securities and Exchange Commission ("SEC") has received a lot of bad press. They are the ones who are supposed to regulate the rating agencies. Admittedly they only have limited authority over the rating agencies; we should fix that. But they did nothing effective, and that could have been the choke point. You never have enough regulators, so you always have to look for the Achilles's heel.

There are only three major rating agencies with twenty good personnel at the SEC. You could have gone in to examine the rating agencies. On Day One you would have discovered the rating agencies were giving triple A ratings to stuff that in my era was referred to as toxic waste. And you would have found out that they did so by deliberately ordering their staff never to examine a single loan file. And you would have found if you examined the underlying loan files that fraud was incredibly common in subprime and nonprime loans. And Day Two you would have ordered that stopped, and you would not have had this crisis. So there was the ability to crack down, even with the limited staff and the limited authority, but there was no one in place willing to do it. We call that de-supervision. The rules are still there, but nobody enforces them.

IV. THE GOVERNMENT'S RESPONSE: BAILOUTS AND MARKET SUPPORT

A. The Rescue of Lehman and Bailouts of Nonbanks

PROFESSOR ARONSON:

Most people would attribute the point in time where we reached a full-blown crisis to the failure of Lehman Brothers, which was September 15, 2008. Early that spring Bear Stearns had been rescued by the government. Lehman was allowed to fail, and that triggered a freeze-up of financial markets. Many countries outside the United States still refer to that as the Lehman shock and, whether rightly or wrongly, blame the United States for causing a global financial crisis. I would like to ask the panelists whether all of this could have been avoided.

More recently, there were a spate of articles in various publications on the first anniversary of Lehman's failure, and more people took a contrarian view that we cannot rescue everyone all the time. We had to let someone go, and since Lehman was one of the smaller investment banks that was not so interconnected to the financial system, maybe that was all right.

Looking at it now, do the panelists think the Lehman bailout was a mistake? And, more generally, should the United States government ever be in the business of bailing out nonbanks, that is, institutions that are not commercial banks that have federally insured deposits?

PROFESSOR SCHOONER:

I would like to answer your question with a question, which we law professors are really good at. I try to go back and think about what the lender of last resort function really was meant to be historically. One of the historical functions of the central bank has been to serve as the lender of last resort, the lender that would lend when nobody else was willing to lend to banks. And that was traditionally limited to banks. And I think back to Lombard Street and the classical view that the central bank should only do that when there is good collateral and it should charge a penalty interest rate. And the idea behind that was to decrease the moral hazard, in other words, to discourage banks from accessing that lending except when they truly needed to and not take excessive risk knowing that they could borrow from the central bank.

So in bailing out the nonbanks, I am not sure whether, first of all, we have a framework for what it is supposed to look like and rules that we can analyze. I think that part of the problem is that we have some history but we do not have useful history in terms of what the rules of that lending should be. And I am not even sure that the recent lender of last resort lending has followed that historical model. So those are my questions that I would like the bankers to answer.

MR. STONE:

I think when you say we are not sure, I think you have touched on it. I think we are in an environment unlike anything we have seen in the lifetime of anybody here. There are some things we do know. We do know that the dollar is unique in the world. It is the reserve currency around the world, and it historically has been for most of the years since World War II. So it plays a different role than any other currency, although there is a lot of noise that maybe it should not be the reserve currency. And although I am not an economist, I think there is no one else that has enough currency to totally replace that role. Therefore, as a practical matter, any lender of last resort for the dollar does play a role internationally that is different than any other central bank in the world. So, people look at us and say, rightfully so, what you do affects me.

And we operate in a capitalistic society in which you must allow failure in order to have a killing frost and clean out the weak spots. And if you subsidize the weak spots—financial, automobile, tire makers, agriculture, anything else—you get a disproportionate effect because that penalizes the more efficient. I am a credit guy, so I think you must allow certain failures. Now, where on that spectrum does our current situation fall? The jury is still out on this crisis, because unlike the crises that we have had since World War II, we had a combination economic crisis and banking crisis. If you look at the recessions since World War II, we have not had that combination in our business lifetime. So I agree that we really do not know all of this yet and we are still learning.

MR. MUNN:

I think we have moved way beyond the lender of last resort concept when we take equity positions. I know we frown on that in banking regulation. You have a bad loan, but instead of loaning you money, we are going to invest, but we then also get a stake in profits on the equity. That is way beyond being a lender of last resort.

PROFESSOR SCHOONER:

We could not value the collateral. That is why we had to take equity positions, and when the collateral has no worth because no one will buy it, it made the traditional function very difficult to deal with.

PROFESSOR BLACK:

I would like to comment from an economics perspective and then a bit from regulation and criminology as well. The Federal Bureau of Investigation ("FBI") began warning in September 2004 in its congressional testimony that there was, "an epidemic of mortgage fraud" developing and that if it was permitted to increase it would produce an economic crisis. Yes, they got that right. So while you had the clear systemic crisis in September 2008, it was absolutely obvious that you were going to have a crisis in 2004. The FBI warned about it. And the assets could be valued in the market. Bankers did not like the values that the market was giving to those assets.

The secondary market was obviously on the verge of destruction no later than 2006, as soon as housing prices stalled, because the only way this thing could work is with refinancing to hide the losses. As soon as housing prices stalled, you could no longer refinance your house to hide the losses, and we start seeing a real surge in delinquencies as soon as that happens. And the eighty percent of the market

that I was talking about (unregulated mortgage lenders) starts failing in 2006. And by 2007 virtually all of them have failed because they do not have deposit insurance. So when they get in trouble in the secondary market, they can no longer sell the toxic waste loans that they have made. If they cannot sell them, they cannot get cash. They cannot get cash from depositors because they are not insured.

So they are all failing in 2006-2007. It is completely obvious in the regulatory ranks that the IndyMacs, the WaMus, the Countrywides of the world are dead, that they are not simply insolvent, they are massively insolvent. At IndyMac it appears that the losses on liars' loans are roughly eighty percent of the original value. If banks have ten percent capital and eighty percent losses on a major asset category, you do not simply fail, you become a catastrophic failure.

These loans had been packaged and put into an exotic instrument called a collateralized debt obligation ("CDO"). And those CDOs had been backed by credit default swaps. And so you have this chain of dominoes that are invariably going to fall. Lehman is not a lender of last resort situation. A classic lender of last resort situation is that you have a creditworthy bank that is the subject of rumors that are incorrect, and there is a short-term liquidity problem. And the lender of last resort, in the United States context, the Federal Reserve, steps in and provides liquidity.

Lehman was deeply insolvent. Bear was deeply insolvent. Merrill Lynch was deeply insolvent. Citi is deeply insolvent. All of these entities have massive unrecognized losses. It is only a question of which are you going to choose to be your precipitating event? So you bail out Lehman. That is going to increase what we call moral hazard in economics and it is going to make new crises—increase risk.

Sooner or later you are going to have to let something fail, and when you do, you are going to have a shock. And there is a new paper by Thomas Ferguson, at the University of Massachusetts, Boston, that shows that there really was a shock to the system. Spreads widened and markets closed down after the Lehman collapse.

B. Necessity of Expansive Fed Programs

PROFESSOR ARONSON:

In addition to the bailout of Lehman and others, the Federal Reserve ("Fed") initiated twenty-five new programs - I think we all got tired of seeing the word unprecedented - and in some cases became the lender of first resort rather than the lender of last resort or the guarantor of many kinds of normal financial activities. And it is not just the Fed; the Federal Deposit Insurance Corporation ("FDIC") has important programs as well. Is that the proper role of our central bank

or bank regulators? Were all those programs necessary and are they still necessary now?

MR. WITT:

Our portfolio is $15 billion or so. We are invested in about every sector of the capital markets domestically and globally. So when I go to bed every night, my head is on the line for all of that. And we were in a very interesting position of touching this crisis every second of every day with our investment portfolio. So I can speak to you with some painful experience. Fortunately, we have danced around all the minefields and that is a whole other discussion.

But we knew that this situation was terribly unprecedented. Should Lehman have been bailed out? Well, hindsight is always 20/20. But when Paulson and Bernanke were looking at that situation it was not clear. What is on this balance sheet? What are the implications of this institution failing? I think they were scared to death.

So, yes, there has there been a proliferation of programs. But the capital markets were very dysfunctional for a long time. Some continue to be dysfunctional, particularly in the securitization markets. One issue is price discovery. If you cannot get a buyer and a seller to agree on a price – that is why the Public-Private Investment Program ("P-PIP") does not work, because you cannot get people together. There is a chasm between the bank not wanting to take the loans off their books at *X* and the hedge fund not wanting to buy at half of *X*. They cannot get together.

You can go into any one program and critique it. You can point to ones that have been failures, you can point to ones that have been successes. And I am a believer in laissez-faire and markets. But I would argue in an unprecedented situation like that, from the standpoint of somebody who operates in the capital markets every day with billions of dollars, many of the programs were necessary just to provide some basic functioning in the market.

We can talk about some programs being too widespread, taxpayers getting their money back, when we should pull away from these programs, and a number of different issues, but I believe that if some intervention had not taken place it is not clear what would have happened with respect to the functioning of capital markets. Did you know that if AIG had not been provided with collateral to back their negative credit default swaps, half the European banking institutions were going down? So what does that mean? Well, I do not know. We have not been there before.

This intertwining means that, at least from my perspective, those programs may not be great, the taxpayers may not get all their money

back, but the capital markets need those programs in order to function.

MR. MUNN:

And that was one of the biggest concerns to Nebraska. We have been untouched by many of the factors that are present in the current financial crisis. But when a funding warehouse becomes dysfunctional, then organizations like Case IH that makes farm equipment cannot offer financing at the dealership because there is no funding warehouse to sell that loan to. And then, of course, that and other equipment loans would eventually be securitized. It had an effect on student loans due to its impact on some of the consumer lenders such as CitiFinancial and HSC. At the state level we were down from about forty-six small loan licenses to people like CitiFinancial and HSC to fourteen licenses over a two-year period. And I think that is the absence of the funding warehouse upstream. So it has had a big impact on Nebraska.

PROFESSOR MITCHELL:

When we talk about the bailouts and this proliferation of Fed programs, I am going to go back to the potential disagreement about Gramm-Leach-Bliley. I agree that certainly one of its consequences was to create financial institutions that were deemed too big to fail. This is a bizarre concept.

The first time I heard the phrase used was in connection with the Continental Illinois bailout, but maybe it was used before. In any case, it was a rare event. And it was the kind of thing you periodically expect in a capitalist system with the same kind of intervention. And I am decidedly not a believer in laissez-faire and markets. But in this case I am not sure that any of the bailouts were appropriate.

Andrew Mellon, when he was Secretary of the Treasury in the early 1930s, was famously, and I think a little bit unfairly in terms of the implication, quoted as saying, "Liquidate everything," by which he meant let everything just collapse. Now, Mellon was a man with some compassion. And the reason that he said that was because in a capitalist system, market failure is the way markets get recreated. That is the way markets begin to reform in a way that eliminates the pathologies that existed before.

So if you really are laissez-faire, I think you have to agree with the proposition that no matter what kind of a mess it would have been, we would have had a natural market reformation. The assets were not going to disappear so long as there was valuing of assets.

People would buy the assets. Markets would start operating again but without pathologies.

Now what we have is a deeply pathological system where the government's fingers are in everything and the government's money is in everything. You all recognize that the bailouts socialized the losses through the gains of the bankers. And when you look at the results of the bailouts in terms of consumers and borrowers and ordinary Americans who had no participation in this, there is no Fed money for them, there is no government relief for them. This all goes into the pockets of finance to sustain the financial system.

It is important that we have a financial system. There is no question about that. But is this the right way to have handled it? That is not clear to me at all.

In addition, it seems to me that allowing the absolute collapse of the system would also have produced something else. There would not have been fights in Congress over whether we should fix things. There would have been no choice. This is what happened in the early 1930s. This is why Franklin Delano Roosevelt, with success or not, mostly not but sometimes yes, was able to force through, over enormous Republican opposition, a lot of economic reforms.

What we see at the moment is the pressure is off. What the bailouts did was to stop us just short of the brink, so that we look like we are recovering. I do not believe for a moment that the state of our financial economy is such that we should take comfort in its long-term security. But bailouts may ultimately take away the political will to reform a system—a system, not just markets, but a system that was deeply in need of reform. So while there would have been an enormous amount of human pain, much worse pain than there is now, the pain would have been shared by the bankers of Goldman Sachs, who appear not to be in any pain whatsoever. That pain would have resulted in long-term good.

There is also an intergenerational problem with equity here. We have just taken your money to bail out our mess, or the bankers have taken your money to bail out our mess. You may or may not see that money back as taxpayers. You may or may not see it back in a solid and sound long-term financial system. There is a moral issue to me as to whether or not this was the right thing to do.

PROFESSOR SCHOONER:

The idea that doing nothing might have put us in a better position for fixing things is an important one. But I observe that, as frustrating as it is, governments never do nothing. If you look historically at banking crises in the last hundred years all over the world, whether

there are explicit insurance guarantees or not, governments always do something. And so I am not surprised that our government tried to do something.

And the proliferation of our programs just makes you feel worse about the fact that we always feel compelled to do something. If you think back a year ago to when the Troubled Asset Relief Program ("TARP") legislation was passed, you may recall that it was passed with the intent that what was going to happen was the government was going to buy these toxic assets. And that is how the legislation was written, that it was $700 billion that was appropriated to buy these toxic assets that banks were holding and could not sell to anybody. But when they tried to implement the program, they encountered incredible problems in terms of valuing those assets. What is the government going to pay for them? How are we going to figure out a price when essentially nobody else wants to buy them? And so that had both practical problems and political problems associated with it.

So then that TARP legislation was read to allow the government to buy equity stakes in banks though this is not entirely clear from the language of the legislation itself. And I do not think that is because we wanted to. I think it was because we felt we had to do something and buying the assets just did not work. So I think you got a proliferation of programs because not all of them were working. It was a hit-and-miss kind of thing.

And we will never know the real impact because we will never know what really would have happened if the government had not intervened. That is the problem with evaluating a number of these measures, including systemic risk. We can define systemic risk, but we do not know it is present until after the fact. These are tremendously difficult problems.

PROFESSOR BLACK:

We want well-functioning capital markets, not as an end in itself, but as a tool to get capital to its most productive uses. And, in that sense, the capital markets did not begin malfunctioning in 2007 or 2008 but in 2001. When the capital markets took enormous amounts of capital and put it into toxic waste that was capital markets not functioning well. That made the world poorer by misallocating capital in a classic economic sense.

We do not want to recreate those secondary markets. When you say that the market does not exist because somebody is only willing to pay $50 for an asset that originally cost $100 and Citi is not willing to sell it for under $90, that does not mean the market is not functioning.

That means that Citi does not want to recognize losses. That is what is going on in those circumstances.

There were many different reasons that particular markets went down. And you have to differentiate among markets, just as you have to differentiate among these bailout programs. So the money market mutual funds really were crashing and burning. They were crashing and burning not because of consumers but because of commercial accounts. The massive wholesale withdrawals were going to bring down the money market system. And that would have hurt many people. And the government stepped in with a deposit guarantee that I think will cost the government nothing. And I think that was a very productive intervention. It is not a good one according to many theories, but I think most all of us support it.

AIG is a really interesting story. We step in and we bail out AIG so the American taxpayers can subsidize European banks to prevent their failure. That is interesting public policy. Was there a vote on that? Did anyone propose that to you publicly? Did you know that $5 billion secretly went to UBS, a giant Swiss bank, while we were bringing a criminal prosecution against UBS because they were defrauding the taxpayers of America, and they settled for a $780 million fine? But if we gave them $5 billion, who really paid that fine? You, the taxpayers of America. Do you know that the only reason we know what happened is because Congress put pressure successfully, not on Treasury and the Fed, which kept it secret from all of us, but on AIG and said there will not be a penny more of bailout funds unless we know who are the counterparties, as the jargon goes, on these credit default swaps? And that we discovered only then that the largest beneficiary was not a European bank but Goldman Sachs at $12.9 billion. And our Treasury Secretary who engineered this had just come from running Goldman Sachs. And the advisory panel included Goldman Sachs, even though it was one of the largest creditors. These are massive conflicts of interest. So there is both a substance issue and there is a process issue.

This has been done in a horrifically awful way in terms of any idea of democratic process. We know the Fed and Treasury were in a state of absolute panic. They themselves did not have good numbers because of the opaqueness of the system. They did not know who the counterparties were. And they were afraid of a domino effect; and if they did not intervene after Lehman the whole system would go down. When you do not have information, when you have to decide in a condition of panic, your decisions are often not very good. So fix the transparency going forward.

C. Crisis Responses by the Bush and Obama Administrations

PROFESSOR ARONSON:

You mentioned the role of the former Secretary of the Treasury who was from Goldman Sachs. And Fed Chairman Bernanke has been reappointed by President Obama. Has there been any significant discernible change between the policies of the prior Bush Administration and the current Obama Administration with respect to the financial crisis?

MR. STONE:

Within my banking experience, I have seen a migration from traditional safety and soundness to safety, soundness and process. And that typically happens at about $10 to $15 to $20 billion of assets. The latest evolution has been safety, soundness, process, and an overlay of social goals. An example of that is the Community Reinvestment Act ("CRA"). And much of this is driven by who defines what the social goal is. But the regulatory process has gone beyond the traditional safeness and soundness.

I think the government did need to intervene. In hindsight maybe not all of them were the right things, history may tell us that, but something had to be done. Many things happened, and sometimes you had very short windows in which to take action.

One action was that the Chief Executive Officers ("CEOs") of the top nineteen commercial banks—which must be distinguished from the investment banks—were called in and given a sheet of paper and told, "You will take Troubled Asset Relief Program ("TARP") money. Do not leave here without signing, and the penalties are onerous." There later were reports about the CEO of Bank of America arguing what the threats were and whether he had to do it. We do not know the details about that, but we do know the bankers were told to take it.

So at that point TARP was, in effect, a good thing. It said—from the bankers' standpoint – I have been identified as a survivor. You can count on me. The federal government has given me TARP money. That happened in the previous administration. The economy has evolved, the oversight has changed and TARP has now shifted to where there is a stigma associated with it. That is a wholesale change and a great deal of it relates to the social goals, whether worthwhile or not, that come with oversight.

One example is Northern Trust Company, which hosted a big golf tournament like they have been doing for years. I do not know whether that was a good use of funds or not, but they thought it was.

It was their decision. They had all kinds of problems in the press. At least one other large bank actually has cancelled a couple of big public events that were already paid for. They did not save any money. But they cancelled because they could not afford the risk to their reputation. And, of course, this can hurt people at the other end who have hotels and catering and such things.

The take-away is the world has changed since the previous administration last fall and the immediate crisis has led to the more stable situation we have now. We are not out of it, but we are not in as intense a crisis. And the regulatory world has changed. And the oversight rules have changed.

And it is not just the financial world. You can look at the automotive industry. The President of the United States said he did not want to micromanage the automobile industry. That sounds great, but within days Barney Frank called the chairman of General Motors in the midst of this huge crisis because he was concerned that General Motors was going to shut down a ninety-person distribution facility in his congressional district. And they did not shut it down. In the grand scheme of General Motors worldwide, this size distribution facility is probably equivalent to a bank changing a teller line by fifteen minutes on Friday afternoon. But the chairman of General Motors will take Barney Frank's call, and they did what he wanted. And the claim was we are not going to micromanage you. The world has changed; it is different.

PROFESSOR SCHOONER:

I think the approach to the crisis has changed. I am not sure it is because the administration changed. I think part of it is because the crisis has continued. Early on in the crisis, the focus was very much on macroeconomic kinds of issues, such as markets and systemic risk. But starting with the Congressional Oversight Panel, headed by Elizabeth Warren, there has been more of a focus on the consumer protection underpinnings to the subprime crisis and reform in that area. I am not sure how big a role that played in the whole crisis. I have become increasingly convinced that at least it did play a role in allowing inappropriate underwriting practices and some of the things that have already been discussed.

So I see more of an emphasis on consumer protection, at least in the legislation that the Obama Administration has proposed. One of the bigger changes seems to be the creation of this new consumer financial protection agency. I cannot predict whether it will ever be passed.

MR. MUNN:

I think that the time lines that the two administrations had with the program were different. Treasury Secretary Paulson throws out a plan for quite dramatic federal restructuring of financial supervision at the end of March 2008, pretty well knowing that it was never going to be discussed in detail. The Obama Administration has a much longer time line to work with.

And I think the financial crisis does not appear to be as severe right now as it was three or six months ago. This leads to an approach of taking some time on financial issues and working first on the health plan in Congress. A Financial Crisis Inquiry Commission was created by Congress as part of the mortgage fraud legislation in May 2008. Their deadline for reporting is December 2010. And there was quite an article in the *American Banker* daily newspaper about this. Should we wait until the Commission issues their report? Should you diagnose the problem before you operate? So I think there is a big difference in time lines.

PROFESSOR. BLACK:

Well, the question of the role of the CRA has a pretty clear answer. So let us play social scientist. The hypothesis is that the CRA caused the bad underwriting and was a contributor to the crisis. Well, the CRA has existed for roughly thirty years so it is a pretty poor candidate to be an independent variable. But it could have changed; how did it change? Did it change in ways that made it far less significant as opposed to far more significant?

So first you get the modifications that are by Gramm, who was the leading hater of CRA, to weaken it. That was put into law in 1999 or 2000. And then you had the Bush Administration. Now, does anyone seriously think that enforcement of the CRA was done vigorously—more vigorously under the Bush Administration? No; in fact, it was consistently weakened. There was expansion in the permissible deadlines, the size of institutions that were exempted from more significant examinations, etc. So it is a terrible candidate variable to try to explain the crisis. If anything, under this theory, changes in the CRA and in its enforcement would have toughened underwriting because the CRA was weakened in its actual enforcement.

More to the point, eighty percent of the loans are made by folks who are not subject to the CRA. And the remainder are made by folks who have One ratings under the CRA. That is how we rate in the

banking system. They had CAMEL-1[28] type ratings—it is not really CAMEL, but it is the same kind of scale. So these were not institutions that were ever in trouble under the CRA. The CRA did not do this. Bankers made subprime loans because they could grow much more quickly, because it was a market that was relatively less tapped and because it had a higher yield. That is why these things were done. So the CRA is a complete red herring at best.

The Paulson plan is really interesting. Because you have to remember Paulson comes into office as the Treasury Secretary with one overriding priority, and that is to gut Sarbanes-Oxley. Paulson comes in and he says the United States is becoming uncompetitive. All the new offerings are going to London. And so he devises an elaborate plan and it is all about weakening regulation. They are going to merge the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC"); they are going to go to CFTC-style regulation because that was historically far weaker. Looking at the plan, you can see it is still the original document that was tweaked a little in response to the crisis. The Paulson plan was dead on arrival on the merits because it did nothing to prevent the burgeoning crisis.

But he brought in Geithner. Geithner was the president of the Federal Reserve Bank of New York. He was supposed to regulate the largest bank holding companies of America, or at least many of them. And he did absolutely nothing effective during this crisis. He did not warn about it. He did not take effective examination steps. He sure as hell did not take effective enforcement or supervisory steps. And so when Obama picks Geithner as Treasury Secretary he is signaling continuation as opposed to a dramatic change.

It is really a very substantial continuation of the prior policies. Now they have the problem that they want to sell reform but they are saying there is no real crisis. And now the modern-day Pecora Commission (the Financial Crisis Inquiry Commission), which was designed to push progress, is going to be used, understandably, as an argument we should not go ahead now. Rather, we should wait for the findings of the Commission before we take any action. And with what we have seen with the emphasis on health care, there is no dynamo in Washington pushing financial reform.

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28. CAMEL refers to a bank's composite safety and soundness rating. It stands for Capital Adequacy, Asset Quality, Management, Earnings, and Liquidity. As of January, 1, 1997 a sixth componenet of Sensitivity-to-market risk was added, and it is now referred to as CAMELS. See, e.g., FEDERAL DEPOSIT INSURANCE CORPORATION, AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S, VOL. I, AT 422, available at , http://www.fdic.gov/bank/historical/history/421_476.pdf

MR. MUNN:

The consumer piece of it probably stands the best chance in the near-term of something happening.

PROFESSOR BLACK:

It was just very substantially compromised by the infamous Barney Frank, so it is already suffering the death of a thousand cuts. I do not think that an effective bill has any chance of going forward without broader reform. If anything comes out, it will just be a complete face-saving, ineffective rule.

MR. STONE:

I brought up the subject of the CRA, not as a cause of the financial crisis, but as an illustration of the migration of the regulatory process from safety and soundness to safety, soundness and process to safety, soundness, process, and social goals.

I think that same thought process would have some bearing on what happened to Fannie Mae and Freddie Mac. If you look at the history of home ownership in our country, it typically was about sixty percent of the families, but during the Carter and Bush Administrations, we got it up closer to seventy percent. There was a social goal of pushing home ownership because that was perceived to be a good thing. But wearing my credit hat, I would say that in hindsight many of those homes were never owned, they were rented. If you get 100, 105, or 110 percent financing on your home, what you have done is you are renting it with an option to purchase if there is equity appreciation. This is not to say there was not greed and fraud in home mortgage lending and that good people got hurt badly. I am not in any way trying to diminish that.

But my point on the CRA is that the regulatory process has become, for better or worse, one in which there is more opportunity for oversight with respect to social goals on top of traditional safety and soundness goals.

PROFESSOR MITCHELL:

Certainly the Bush Administration pushed home ownership really hard. But Freddie and Fannie historically were formed after the mortgage crisis of the 1930s. And they were actually formed not so much to push home ownership as to stabilize the mortgage industry and to provide some kind of federal backstop or guarantee to the mortgage industry. The mortgage industry that had started out essentially eighty percent unregulated wound up creating many of the mortgage

products which, while not as exotic or elaborate as the ones in the current crisis, were also toxic waste. But social goals changed. If Freddie and Fannie had stayed true to their mission, without the push to this home ownership society, they probably would have been fine.

PROFESSOR BLACK:

I was an expert witness for the government in its case against Frank Raines, the head of Fannie Mae. So I am a pretty virulent opponent, and I do not have much good to say about the Bush Administration. Historically Fannie and Freddie did the opposite. They were the ones that created the concept of a prime loan, by taking very tough standards and making them tougher. So they looked nationally at standards, and they were the primary source of private market discipline on the secondary market.

What changed was private label securitization. It is the private label folks that did essentially all of the securitization that created the collateralized debt obligations ("CDOs") backed by toxic waste. Fannie and Freddie did virtually none of that pooling, even when the Bush Administration was pushing for the ownership society.

So Fannie and Freddie do eventually get into enormous trouble, but it is mostly by purchasing liars' loans CDOs. And they did that not because they were being pushed by the Bush Administration, and assuredly not because of a social goal, but because the government had cut off their prior strategy of rapid growth of their portfolio with enormous bonuses, and they scammed their accounting. The SEC caught them and made them restate their financial statements, and it took them a year and a half to be able to file performing GAAP statements. That is how bad their accounting was. Well, they could no longer grow like crazy to make their bonuses. So they needed some hyper-concentrated yield, and that is when they went overwhelmingly to the CDOs.

So I do not think it actually had anything to do with their social goals or anything to do with Bust Administration pressures. Rather, as we discussed earlier, be careful what you incentivize. And they incentivized short-term accounting gains.

MR. STONE:

If you incentivize short-term growth and profitability at the expense of long-term soundness, you will get short-term growth and profitability at the expense of long-term soundness.

MR. WITT:

I think the life insurance industry may be the prime example. Note the opposing interests of the various stakeholders in this institution. I operate within the framework of a life insurance company. Who are my stakeholders? Well, I have a board of directors. I happen to be a mutual company so I do not have stockholders but I have policy holders. But I also have rating agencies and others who watch me from the standpoint of how I am doing with efficient returns on capital and how I can access capital in the markets to continue to grow my organization and expand my profitability.

My regulator friends would say, quite appropriately, that we measure you on cash-based statutory accounting, not this funny GAAP stuff that matches up income and expenses. And, by the way, more surplus is better. We do not care how big your equity gets. A bigger pile of equity gives a cushion of estimated reserves. But on the other hand, the providers of capital say, well, that is bad. I want you playing with your leverage ratios and driving up the numerator and getting good returns on equity or I am going to take my capital away from you and I am going to give it to somebody else.

So certainly in the insurance industry, and to some degree in others as well, you can see a conflict of interest. The different interests of the various stakeholders, all of which are not necessarily inappropriate but sometimes can be in conflict, cause a creative tension line that moves through many financial institution marketplaces.

V. HISTORICAL ANALOGIES AND LESSONS

PROFESSOR ARONSON:

In the discussion of the financial crisis and measures to deal with it, we have had quite a number of historical analogies used by people making various arguments. Federal Reserve ("Fed") Chairman Bernanke is well known as a student of the Great Depression. Treasury Secretary Geithner was an economic attaché at the United States Embassy in Tokyo earlier in his career. And, from very different experiences, they both apparently drew the same lesson, which is to keep stimulating and providing money, and do not worry about how much you have spent. If you do start worrying and withdraw the stimulus prematurely, the crisis will be prolonged and get worse. And that is the lesson they drew from the United States in the 1930s and Japan in the 1990s. Is that the correct historical lesson we can draw from dealing with financial crises, just stepping on the gas pedal? What is the downside of that lesson if there is one?

PROFESSOR MITCHELL:

It depends on the nature of the crisis, correct? As discussed earlier, we have in effect two interwoven crises: A banking credit crisis and an extraordinary recession. They are related, but it is hard to say exactly how. Economists are still fighting over the extent to which the stock market crash of 1929 had anything to do with the depression that followed.

If you are in this kind of recession – people call it a recession, a great recession or quasi-depression – you do not start dealing with the deficit. That is exactly what Franklin Delano Roosevelt did in 1937 and took the depression, which was almost finished, and crashed the economy right back down again. What you do is you need to spend. In fact, to me one of Obama's worst moments was the day this past spring he said "I'm going to start dealing with the deficit."

You do not spend with tax cuts. That has been proven not to work. And so part of the problem with the Obama stimulus program, and I understand it as a political compromise, was that one-third of the money went to tax cuts. It is true that some of the stimulus money is going to projects that need some time to get started. But that is the way, at least from a realistic economic standpoint, that you actually get out of the recession. You need to create jobs. This is an economy, for better or for worse, which is almost entirely consumer-driven. You need to create jobs so that people will make money and spend money. Not by borrowing – by racking up large credit card bills and then securitizing those assets and selling them – but by creating jobs and creating production.

Up through the mid 1960s, American business financed itself internally, raising fifty percent, and sometimes as high as sixty-five percent, of investment capital from its own retained earnings. It did not go out and raise money from the stock market. The stock market has never financed a mature industry. These are financed through retained earnings, used for investment, and borrowing the rest, usually short-term trade credit and some long-term debt.

By 2002 retained earnings accounted for three percent of corporate financing. Well, where did the money go? It did not come from equity – net equity issuances were negative. They were flat through the 1970s, and they were negative in the 1980s and 1990s. Even with all the new Initial Public Offerings ("IPOs") in the 1990s, net equity issuances were negative. It came from debt. As the bankers know, much of that debt was stuck off-balance sheet so you could not even know it was there.

The research over the last few years has absolutely convinced me you keep your foot on the pedal hard, spending and not worrying

about deficits yet. We have a credit crisis; it is an adjunct to this recession. Banks are still not lending money, certainly not lending at a level that can sustain the kind of productivity we need. You are not issuing equity. So where is the money going to come from? There is only one place and that is the federal government. And that is why I think the answer is, yes, spend.

PROFESSOR BLACK:

Let me focus on the Japanese part. We both studied the Japanese crisis. And that makes Geithner's experience and the conclusions he draws from the experience all the more interesting. Geithner is not someone with an economics background. His background is in international studies. So if he had the economic slot in the Embassy, that is an interesting thing in itself.

Japan promptly went to a very expansive fiscal policy. And it went pretty quickly to what we would refer to as a zero interest rate policy. In other words, the Bank of Japan lowered short-term interest rates to zero. Japan in 1990 suffers the collapse of what they call the twin bubbles, in real estate and in the stock market. Their stock market, the Nikkei, is still roughly at twenty-five percent of its peak value nearly twenty years ago. Can you imagine the Dow Jones losing seventy-five percent of its value and staying that way for two decades?

So you can imagine how bad this can get. But what else did Japan do? It initially – and initially means six years – covered up losses in the banks. And unlike in the United States, as weak as our capital markets are, the capital markets in Japan are far weaker. So overwhelmingly finance comes from the main banks. You may have heard of the keiretsu, Japan's large industrial groups. If the main bank is hurt, the entire keiretsu is going to be in big trouble as well. And if your financing overwhelmingly comes from those banks, you can see why you are going to have enormous problems even with an expansionary monetary policy.

Now, what do they do on the fiscal side? They decide to pave the nation with concrete through public works. A large part of this is various maladies we will not go into involving corruption with "dango," a closed construction bidding system in Japan, and the Liberal Democratic Party ("LDP"), which until very recently was the permanent ruling party in Japan, and within the party "tribe" politicians who got kickbacks from construction interests.

So investment was made in unproductive ways. Banks could borrow at zero and they could invest in longer-term government securities and make three-hundred basis points. That is a three percent spread. So they were guaranteed to make money. It is an implicit

subsidy that you do not have to pass through the Diet, their parliament. You do not have any political problems and the bankers are happy. The economy sucks. They refer to it as the lost decade. It is rolling recessions and it is really becoming closer to two decades.

I very much fear that Obama is taking us, under Geithner, down a very similar path. And it seems truly odd given his background, which includes not just Tokyo but the Asian currency crisis as well, which he was somewhat responsible for dealing with while at Treasury. Very ineffectively, I might add.

PROFESSOR ARONSON:

One problem the Japanese had was the difficulty in taking bad loans off the banks' balance sheets and having the banks recognize their losses. One important reason for that, as you mentioned, was they were worried about the corporate borrowers and the strength of the economy and employment issues.

PROFESSOR BLACK:

And construction workers. They used that as a reservoir to help the keiretsu. At the heart of each keiretsu is a large bank which provides the financing or at least the primary financing for the entire group. So if that bank gets in trouble, it is not just the unemployment for awhile.

PROFESSOR ARONSON:

So are we really going to do better? It seems to be quite difficult. It is easy to wait for the economy to get better, where a rising tide lifts all boats. It is very difficult and painful to go through bank by bank and say we are going to recognize losses and corporations will not have funds available, and they are going to fire people.

PROFESSOR BLACK:

But, you see, this is a real sea change in the United States, because for fifteen years after the Japanese crisis, every Treasury Secretary in the United States, Republican or Democrat, went over to Tokyo and said, you are wrong by covering it up and not dealing with it. You should do what we did in the United States Savings and Loan crisis. Take the pain of actually doing the closures. None of those savings and loans were treated as too big to fail. Not only did the equity owners get wiped out but the subordinated debt holders get wiped out in every single case. They are supposed to be providing risk capital in

theory. So where did that fifteen years of bipartisan consensus go as soon as we got in trouble?

MR. STONE:

Not recognizing losses is a fatal path for a bank. You have heard the saying that a rolling stone gathers no moss. In the old banking world they used to say a rolling loan gathers no loss.

As a chief credit officer I am adamant that you must set up a culture where you reward people for finding problems early. And by reward I do not mean financial reward. But you can inadvertently penalize people if somebody comes in to you with a problem and your response is, "Oh, my gosh, how did you let that happen?" And if you cyclically punish them, you have people who think that hope and time might be the solution and so let us not talk about this. The behavior you want to reward is lots of eyes and attention to get to problems early and do whatever you need to do to resolve them.

MR. MUNN:

It is important to extend the period over which performance of a particular loan officer or loan administrator is measured rather than focusing on short-term loan production.

MR. STONE:

And I think that is true in the communities in Nebraska and everywhere else, including Japan. Pardon my country boy expression, but if it lands with a bunch of ducks and it quacks and it swims and it has webbed feet and it eats bugs, it is probably a duck. And if it is a duck, call it a duck.

MR. MUNN:

Any state-chartered Nebraska bank has to choose either the Fed or the Federal Deposit Insurance Corporation ("FDIC") as a federal regulator. The extent of the forbearance that we are seeing with performing loans, that if the appraised value of a commercial project has fallen to a point where it is below the loan balance, a loss will not be mandated on that particular credit if that loan is performing. That is about the extent of it.

VI. FOREIGN BANKS AND GLOBALIZATION

PROFESSOR ARONSON:

I would like to ask about the expanded role of the Federal Reserve ("Fed") in the global financial crisis. Unlike anything that happened in the past, the Fed is now dealing extensively with foreign banks and encouraging them to participate in its various programs to support financial institutions, and is extending swap currency lines to other foreign central banks. This has not received a great deal of attention, but I do not think it has ever happened before. Has the Fed to some extent become the central bank for the entire world, and is that appropriate given the global dimension of the crisis, or is that overreaching?

PROFESSOR BLACK:

Yes, it effectively became the central bank to the world. As we discussed earlier, the United States dollar is the reserve currency in the world. While you might think the United States is weaker, in some ways it is actually much more dominant than before this crisis, precisely because it turned out that only the Fed could play this role.

The European Union has a very different form of central bank. And essentially the national central banks do not count anymore in Europe. The European central bank is not permitted to consider employment goals. It is only supposed to deal with inflation. It is not set up to be a lender of last resort. It is not even set to be a liquidity provider, which is a different function.

So when we have problems, one of the things we do very quickly in the modern era, the modern era being the last twenty-five years, is flood the markets with liquidity when we have a Black Monday, and that action is not very controversial among economists. That is a very good thing to do, but Europe cannot do that. It also has a great deal of debt denominated in dollars. And so they have a problem, how do they get dollars? And the Swiss in particular could not get dollars, and UBS probably would have failed. And it may not have been the only large Swiss bank that was going to fail.

So I do not know that it would have been a terrible thing for the world if UBS failed, given its incredibly bad track record. If there were a three strikes law for banks, they would have been done away with many, many strikes ago. But you can see why the authorities were worried about the crisis.

When the Fed makes those kinds of loans, it is taking a very substantial credit risk. There is really not much backing; even we cannot go and sue the central banks. And even if we did, there is nothing

much to grab even if we could win a judgment. It would also cause huge problems in a country like Switzerland if we pursued them.

So I do not think that is a high risk, but it is still a dramatic change for anyone who has dealt with the Fed. In the past, the Fed never took credit risk. If you had to go to the Fed as a lender of last resort, you would rue the day because they were going to do so many things to you. They just would never take even a penny of credit risk. Now, they take it and measure it in literally hundreds of billions of dollars.

PROFESSOR ARONSON:

By coincidence, in the late 1990s when I was practicing law in New York, I was the first person who went to the Fed representing some foreign, in this case Japanese, banks who wanted to be eligible to borrow from the discount window in support of their dollar-denominated assets. The law was on our side, and we were ultimately able to make the necessary arrangements, but the Fed was extremely cautious. They made clear that access would be limited to support for dollar-denominated assets. They would only accept the best collateral, such as United States Treasuries, for any discount window borrowing. They said to us frequently that "Remember, we are only the lender of last resort and we do not take any risk." That fundamental approach has very significantly changed within a relatively short period of time.

PROFESSOR BLACK:

That means they have very few people that actually understand credit risk on the business side. It scares me to death because when you never accept credit risk, you do not have the necessary systems, people, experience, or judgment. I have been on a credit committee and I would not want a lot of these people on a credit committee.

PROFESSOR MITCHELL:

There is a political issue with the Fed having gone as far as it has. This crisis can also be seen as a national security threat. We did it, we started it, we caused the problem. And it was not like the Europeans were not plenty mad at us when this happened. Not that they did not have their own share of participation in it, of course, but this all originated here. And so to me the Fed's taking responsibility in this matter is actually a very important aspect of America regaining some credibility for financial leadership.

PROFESSOR SCHOONER:

The development of international networks might also have contributed to the Fed evolving into this role. The Basel Committee on Banking Supervision which meets at the Bank for International Settlements ("BIS") has been the forerunner in creating international standards of capital for large banks and even small banks. And I wonder if those relationships were not in place already on the supervisory side, whether that would have changed the crisis. My guess is that the BIS made dealing with the crisis easier. We already had that network in place, and bankers were already talking to each other regularly about things like capital standards and their relationship to being lenders of last resort. I think that they are intertwined.

VII. SYSTEMIC RISK AND ITS REGULATION

PROFESSOR ARONSON:

We have mentioned systemic risk, too big to fail, and some of the problems involved in those concepts. Under the Obama Administration plan we are going to have a new systemic risk regulator, which is going to be the Federal Reserve ("Fed"). Is it a good idea to have a systemic risk regulator, and, if so, is the Fed the appropriate institution to do it? Do we have an appropriate institution to act in that role? What do you think about the administration's plan?

PROFESSOR SCHOONER:

I think if you are choosing among existing agencies, it is natural to look at the Fed. I am not sure they have a great track record for preventing systemic risk, although, in their defense, I am not sure they were trying to do that.

They have served, since Gramm-Leach-Bliley, as the umbrella regulator for commercial banking institutions, so they ostensibly have some experience dealing with consolidated and diverse institutions, but they were not dealing with the investment banking side. It is hard to say whether they can do it better than anyone else.

A unique problem with giving this role to the Fed is the Fed is always admired for its independence around the world. Developing countries often try to copy our system of creating a central bank for that reason—on the central banking side, although not necessarily on its regulatory side, it operates with a large degree of independence. If you expand the Fed's charter from unemployment and price stability to include systemic risk, will it potentially lose some of that independence? Is that more political than the other two goals? I am not sure

it is, but it certainly would be a different goal than it has normally sought to achieve.

PROFESSOR BLACK:

Well, the Fed should certainly lose independence to the extent it becomes a lender. If it is going to be lending our funds, that is not something for which you need independence. Rather, you need someone like an outside auditor who was aggressive and asked hard questions and looked at the incentive structures within the organization. I do not think the Fed is a natural place to regulate systemic risk. They certainly were purporting to look at systemic risk. In fact, never have people gone on about systemic risk as much as the Fed economists did this entire decade.

And looking at Fannie and Freddie, their dynamic hedging created a giant, glaring systemic risk right in front of them and they never saw it. Look through the Fed papers and you will find that during this biggest crisis that anyone in this room has ever experienced, the Fed has done virtually nothing meaningful about the actual systemic risk they are facing.

What is the problem with the Fed institutionally? Institutions have cultures. In the Fed's culture the only thing that matters is monetary policy. Everything else is shunted to seventh or eighth level priorities. If you are a regulator type in the Fed, you are way down in the pecking order.

The Fed's professional culture is entirely economists. And if you want the worst possible group to actually identify systemic risk in the modern era it would be Chicago School economists. They know you cannot have these risks, because they cannot happen in an efficient market. And so they have zero training that is relevant to identifying the actual risk. They are the ones who brought us the Basel II process. And what did the Basel II process tell us? Big banks have excessively large capital. They are not leveraged enough. Remember the discussion we have been having today?

The second point under Basel II was that as long as banks are investing in mortgage product with triple A ratings, they should have a particularly low capital requirement. So you could have toxic waste stuff worth twenty cents on the dollar now, but if you have a triple-A rating you should not only be allowed to invest in it, you should be encouraged to invest in it by increasing your leverage and by decreasing your capital requirement.

And, third, they said the best system is for the big banks to use their own proprietary models to value their assets. That means it is completely nonregulatable. No examiner can deal with the proprie-

tary model of the Goldman Sachses of the world. The Chief Executive Offices do not understand proprietary models at any of these places, not a single one. But the people constructing the models understand something very well, and that is incentives. And that is, they get a bigger bonus if the asset values are higher. And they know in finance if you reduce the quantification of the risk, definitionally the asset value increases. And so they construct models that systematically understate risk and overstate asset values. And that makes markets incredibly dysfunctional.

It would be the same folks that created these stress tests. Stress tests are a farce at the big banks as well. By the way, we mandated stress tests by statute fifteen years ago at Fannie and Freddie. How did that work out?

MR. STONE:

I do not think we could get the six of us on this panel to agree what constitutes systemic risk. I do not know anybody that can define it; I cannot. We certainly can identify extremes. But on the cusp what is systemic risk? How can we regulate it if we cannot define it?

PROFESSOR SCHOONER:

I think we can define the results, not what causes it.

MR. MUNN:

I have seen a great deal of resistance to the idea of the Fed being the sole systemic risk regulator. I represent all state financial regulators on the Federal Financial Institutions Examination Council ("FFIEC"). I go in every three months, meet with Chairman Bair, Comptroller Dugan, Governor Tarullo, the acting director of the Office of Thrift Supervision ("OTS") and the chairman of the National Credit Union Administation ("NCUA"). Each one of those is pushing hard to be a member in some manner of a systemic risk council. And now Barney Frank comes up with the concept for a Consumer Financial Protection Agency, and I will be on the oversight board if his plan comes to being. So I would not put my money on the Fed right now to come out as the sole regulator. And this would also involve regulators from other areas like the Securities and Exchange Commission ("SEC") and CFTC.

VIII. CONSUMER ISSUES AND EXECUTIVE COMPENSATION

PROFESSOR ARONSON:

Let's talk about consumer issues.

There is a perception by some people that the government has bailed out Wall Street, the big financial institutions, but has not done much for consumers. Is that true? If it is true, is that necessary to first stabilize the financial system?

Another issue that really got people excited was executive compensation for bankers. Our local talk radio station tracked me down when there were stories about AIG executives getting big bonuses and the Treasury said they had to pay them because that was in the contracts. The radio station wanted to know "Is that true? That's outrageous! What's the story?" AIG's executive compensation really caught people's attention. Is that a significant issue, or is it a populist distraction?

PROFESSOR MITCHELL:

That is not an easy yes or no. While I find bankers' compensation in some abstract, but nonquantifiable way, disgusting, I think it is a distraction. I think the incentives are the issue, that is, what are the incentives that create that pay? If the incentives are short-term, that is a problem. But I do not think the size of the compensation itself per se is a central issue. And, in fact, if everything else were in order, that would take care of itself just fine.

PROFESSOR SCHOONER:

With respect to your Wall Street versus Main Street viewpoint that we have been hearing a great deal about the last year, I think if you believe systemic risk is an important issue, then you must believe that you have to deal with systemic risk to help Main Street. So I think it is really a huge issue. If you do not really believe that you need to help the financial institutions first, you are saying systemic risk is not really all that important and that we should just let things take care of themselves. I am not sure what the answer is, but I think it is a fundamental question.

MR. WITT:

Although I think executive pay is a distraction, there is an important question in where should the responsibility for that issue lie? Where are the board of directors? They are representing stakeholders, whether it is a public or mutual company. And although I am not

a fan of regulation, Sarbanes-Oxley and other laws pointed out to boards that they have responsibility, if not culpability, and that they need to focus on corporate governance and committee structure. We have done that in my company, even though it is a mutual company and not a public company, and that has been valuable. I touch it every day. I report to five members of the board of directors as an investment committee. I am happy to get them out of town on Wednesday.

I would return to the issue of short-term incentives versus long-term incentives as they relate to quarterly earnings reports. A Chief Financial Officer can come down to your office and say, "I'm three cents a share short this quarter, find me something." This can happen because so much of what goes on in corporate accounting, quarter to quarter, is estimates. I mean there are estimates you are working through now and the next estimates are coming that you are working on, and the next estimates are coming after that. One of the challenges is that people do what they are incentivized to do. And if you do not like what they are doing, try and figure out how they are being incentivized. You may have a formal incentive to achieve a stated goal, but you need to get under the covers and figure out how they are really incentivized. So if it is a question of long term versus short term, I would say that rethinking or rebalancing is needed to achieve the results that you want.

And I will use myself as an example. What do I do all day? I manage risk. Investment returns are a residual for managing risk. My incentives balance return and risk. And so I have that creative tension going every day between short term and long term. And I have both incentive plans; I get paid annually and I get three-year deferred compensation. They are all linked to balancing return and risk. It goes back to making sure you have the right incentives in place to deal with the issues.

Boards need to step up. And if those people are not doing their jobs, then get them out of there and get people that can step up and do what is necessary. If we introduce government into it, it will be inefficient and it will be inappropriate. Sarbanes-Oxley caught the one-tenth of one percent of bad guys, and all the rest of us had to deal with issues because of it.

MR. STONE:

If we are looking at extending credit to a publicly owned company, I will look at the directors. What is the degree of independence? How many inside, how many outside directors? The best indication of what they are going to do is what they have done. I want to see their history. I want to see who chairs the audit committee. If the chair of the

audit committee is a professional athlete who has never had any financial experience, that does not resonate well with me. I did not make that up. So the board of directors is a very key element in assessing how that company is looked at and whether we want to extend credit to them. That is where the responsibility ought to be.

PROFESSOR BLACK:

Executive compensation is the heart of the problem because of the incentive structure. The intellectual godfather of it, Michael Jensen, has turned on it as his Frankenstein creation. It is not one-tenth of one percent. If you look at all of the specialty lenders and subprime, you are going to find that all of them put their loan officers on volume bonuses, all of them.

MR. WITT:

I was speaking about corporations generally, not just financial institutions.

PROFESSOR BLACK:

It is the same for corporations generally that use short-term incentives. You can look at the number of restatements and see it is a vastly higher percentage. And you can look at the studies done on backdating stock options and it is a vastly higher number.

So this is not some tiny little malady. It is the modern world that is causing the worst failures: If you incentivize it, they will do it. And you may have very good boards. There are many boards that are controlled by the Chief Executive Officers. In fact, that is why Jensen created executive compensation. He said you had to change that substantially. So I think we have a difference empirically. And studies show that since the financial crisis executive compensation has become more short term instead of less short term. That is scary.

IX. QUESTION AND ANSWER

AUDIENCE MEMBER:

I have a two-part question. One, part of the start of the crisis was the extremely low interest rates that were maintained for an extended period of time following the tech boom crash. This sent Wall Street looking for somewhere to make some money and they ended up finding consumers. So how do you avoid that same situation when we are putting possibly even more liquidity in the system? And two, behind the collateralized debt obligation ("CDOs") and other securitizations,

there are many times when a person signed a loan contract. What could or should we do to address the accountability that the public has for creating the crisis?

MR. STONE:

There are plenty of guilty parties—failures are orphans; successes have thousands of fathers.

Whether you are talking about a grand scale or a hometown in Nebraska, credit is not that complicated. Loans get repaid in one of three ways. The best loan to me is a loan that gets repaid by increasing earnings. We are going to make a manufacturer's production line more efficient, build a better product, or something else to increase their earnings. That is going to come back. The second best loans get repaid by conversion of assets. That is your farmer in Nebraska. We lend him money for seed and fertilizer in the spring, and he grows corn and soybeans. And when the harvest comes in he pays us back. That is conversion. Your third best loans get repaid by somebody else taking over the debt. That can be the greater fool theory, but in the commercial real estate area that is frankly what we do. Banks make construction loans with the anticipation that an insurance company or somebody is going to take us out of that debt. And one of the fundamental questions is, what is the source of repayment? And you identified it there.

We got so exotic that we did not know the source of repayment. Securitizations were highly rated and complex. We forgot to ask that question: what is the source of repayment fundamentally? That is the second part of your question.

MR. MUNN:

As far as the position of the consumer in the hierarchy that you mentioned, I think implementation of mortgage loan originator licensing in the nonbank world and mortgage loan originator registration in the bank world will go a long way. Each person originating mortgage loans will have a unique identifier. They can track that person to the end of the earth, including what security that loan went into. I think the government can play a role to help.

PROFESSOR BLACK:

As for the first premise, people say that all the time about low interest, but it makes no sense economically. If I have a lower interest rate and I am an investment banker, that means my cost of funds is

down and, all other factors being held constant, investments are more valuable.

I could borrow more and loan more, but no one has a gun to my head. I chose to leverage. I was not forced to leverage by lower interest rates. So I think that is really bad financing and bad economics.

MR. WITT:

You described the carry trade. The bad news today is that the carry trade is coming back. And one of the contributors to it is the Federal Reserve ("Fed") pushing so much liquidity into the system with short-term rates at zero to one quarter of a percent. So if you do not have the proper disciplines and controls, you morph over time from borrowing short and lending long to borrowing short and lending stupid. And that becomes the issue: where is the point of inflection when that starts to take place? You can describe it in some sense and that is the place where the regulator needs to raise his hand and speak up.

PROFESSOR BLACK:

The accountability question is a fascinating one. I do not understand why we need a new consumer agency, or why anyone would propose a new agency.

The Federal Bureau of Investigation ("FBI") says that eighty percent of the fraud losses come when lender personnel are involved. So in criminology these are what we call control frauds where the institution has a strategy that it profits by making fraudulent loans. Now, it only profits the institution in the short term, but the short term can be really, really good and that is why the aggregate amount of compensation matters. If I can get really rich in three years, then it does not much matter what comes afterward.

The FBI only began to look at the major specialty subprime lenders in March 2007, non-coincidentally when the secondary market collapsed. But here is the pattern they are finding. It raises the accountability issue and the issue that some people have on this kind of proposed consumer agency.

First, you have a whole group where the institution created the false numbers. Sometimes they did that directly. Sometimes they said just sign your name here and they filled in the forms. You have a whole group of folks, we could call them the working class – and in particular we could call them minority working class – that were brought in at the worst conceivable time to loans they could not possibly repay.

And so this crisis has been the biggest single destruction of the not very substantial wealth of working class Americans in anybody's lifetime. And that is particularly true of minorities. And it is very particularly true of people whose first language was something other than English and could not understand these forms at all. You have other folks who were actively complicit with lending officers and with title officers. I do not have much sympathy for those folks. And you have some folks who were doing the scam and the bank was actually truly innocent and had controls and it simply missed them. And, again, I do not think anybody has any sympathy for that group of folks.

X. CONCLUSION

The fundamental issues of financial system reform emphasized by the panelists—including the importance of executive compensation and the structuring of incentives, systemic risk and the problem with having the Federal Reserve ("Fed") as its sole regulator, and financial regulatory reform as a legislative priority—have achieved new prominence in the months following the panel discussion held in September 2009.

Executive compensation, in particular Wall Street bonuses, has become a hot button political issue with congressional proposals for a tax on bankers' bonuses and the investment banks both reducing their employee compensation as a percentage of firm revenue and emphasizing their charitable works.

With respect to systemic risk, the Obama Administration recently took a more radical approach by emphasizing the "Volker Rule," which would resurrect a form of Glass-Steagall and prohibit banks from using government-insured funds for proprietary trading.[29] The prospects for the administration's original plan to make the Fed the sole regulator of systemic risk have become highly uncertain. The Fed's reputation and credibility have come under attack, with new congressional proposals for audits of the Fed and a relatively slim Senate confirmation vote (seventy to thirty) on the reappointment of Fed Chairman Bernanke amidst criticism that governmental actions were benefitting Wall Street rather than Main Street.

29. *See* Press Release,White House, President Obama Calls for New Restrictions on Size and Scope of Fin. Inst. to Rein in Excesses and Protect Taxpayers (Jan. 21, 2010), *available at* http://www.whitehouse.gov/the-press-office/president-obama-calls-new-restrictions-size-and-scope-financial-institutions-rein-e (this proposal would strengthen the administration's original financial reform package by prohibiting banks from proprietary trading or owning or investing in hedge funds and private equity fund, and by new caps on the size of bank liabilities to supplement the existing restriction on a bank's market share of deposits).

Finally, after a year of focusing primarily on health care reform, the Obama Administration recently announced new priorities for its second year consisting of an emphasis on job creation, deficit reduction, and financial regulatory reform. If the Obama Administration wishes to salvage its opportunity to "never let a serious crisis go to waste," it would do well to move forward quickly with financial regulatory reform which addresses the issues highlighted in the panel discussion.

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