

SHAPING GLOBAL FINANCIAL REFORM: A SYMPOSIUM  
FOR PRIVATE AND PUBLIC SECTOR LEADERS

PROCEEDINGS SUMMARIZED BY  
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On April 23, 2009, United States and international financial leaders from both the public and private sector gathered at the Willard Hotel in Washington D.C. to discuss global financial reform. The symposium—entitled “Shaping Global Financial Reform” and co-hosted by the Bretton Woods Committee, the Morin Center for Banking and Financial Law, and the Deloitte Center for Banking Solutions—addressed international, domestic, and structural reform necessary to improve and stabilize the financial systems that currently exist.

While the symposium speakers and panelists had a variety of diverse viewpoints regarding financial reform, there were basic issues on which they managed to come to a consensus. There was agreement that systemic risk needs to be regulated and that there should be one overarching regulator for this task; that the securitization process and the capital markets need to be subject to some more stringent regulation; that there needs to be international cooperation and standardization in both regulation and crisis resolution of the financial system; that there needs to be a mechanism to deal with market procyclicality; and that a new structure of regulation should carefully monitor the incentives of market players.

***I. Opening Remarks***

Cornelius Hurley, Director of the Morin Center for Banking and Financial Law at Boston University School of Law, gave the introductory remarks. He noted that the distinguished individuals in

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the room would be the driving force behind financial reform in the U.S. in the upcoming several months. In recognizing conference attendees, speakers, and panelists, Hurley pointed to audience member Brooksley Born, Former Chairman of the U.S. Commodity Futures Trading Commission (“CFTC”), as one of the important “people of character, conviction, and courage who are able to speak against the prevailing wisdom of the day” and who are necessary to bring about important change. Robert A. Brown, the President of Boston University, discussed the necessity for a “comeback” to restore confidence in the financial system that he said would emerge from Washington D.C. In reforming a broken financial system, President Brown concluded, “comebacks are possible, no matter how impossible.”

## **II. *Sheila C. Bair***

Sheila C. Bair, the 19th Chairman of the U.S. Federal Deposit Insurance Corporation (“FDIC”), delivered the opening keynote address at the conference. In a frank and informative fashion, Bair described and commented on the recently implemented government programs for financial system relief and provided her account of worthwhile and necessary future reform.

Bair stated that U.S. regulators have had a tough time instituting appropriate responses to the financial crisis and described several such responses. Bair stated that in light of the uncertainties and failings of domestic and global financial systems during the past eighteen months, the FDIC, the Federal Reserve Board, and the U.S. Department of the Treasury (“Treasury”) have taken some extraordinary steps in attempts to stabilize the financial system. As examples, Bair noted the “heroic” efforts of the Federal Reserve Board in its implementations of various facilities<sup>1</sup> aimed at providing

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<sup>1</sup> The list of programs includes the Term Asset-Backed Securities Loan Facility (“TALF”), the Term Auction Facility (“TAF”), the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (“AMLF”), the Commercial Paper Funding Facility (“CPFF”), the Money Market Investor Funding Facility (“MMIFF”), the Primary Dealer Credit Facility (“PDCF”), the Term Securities Lending Facility (“TSLF”), and temporary reciprocal currency arrangements (“swap lines”) between the United States Federal Reserve Bank and central banks outside of the United States. Press Release, Board of Governors of the Federal Reserve System, Federal Reserve Announces Extension Through October 30, 2009, of its

stability and increasing liquidity, and the Treasury's Troubled Asset Relief Program ("TARP"),<sup>2</sup> which she described as unpopular yet necessary to ensure that banks have adequate access to capital to be able to continue their lending activities. Bair stated that the FDIC is pleased to collaborate with the Treasury in the Legacy Loans Program ("LLP"),<sup>3</sup> which will repurchase troubled assets from FDIC-insured banks. The plan is to begin the program with a "test drive" so that everybody can understand how the LLP works, and the FDIC and the Treasury hope to have a pilot sale at least by early June. In response to a question regarding the LLP, Bair stated that while the program will not itself solve the crisis, "it's an important piece of the puzzle and also can provide an orderly way for banks to start cleaning up their balance sheets without everybody running to the market at once." She stated that the criticism of the program focuses on the failure to adequately approximate market prices: "[Of the two chief criticisms of the program,] [o]ne says that the banks are going to get sweetheart deals. The others say the investors are going to get the sweetheart deals. So the truth is somewhere in the middle." She stated that there has been a large amount of investor interest in the program and that if there is a pricing problem, "it's going to be lowball prices." The FDIC consequently is exploring this issue and

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Existing Liquidity Programs That Were Scheduled to Expire on April 30, 2009 (Feb. 3, 2009), *available at* <http://www.federalreserve.gov/newsevents/press/monetary/2009monetary.htm> (follow "February 3, 2009" hyperlink).

<sup>2</sup> Treasury instituted the TARP Capital Purchase Program on October 14, 2008, pursuant to which it was authorized to purchase up to \$250 billion of senior preferred shares and warrants on standardized terms from various United States financial institutions. Press Release, United States Department of the Treasury, Treasury Announces TARP Capital Purchase Program Description (Oct. 14, 2008), *available at* <http://www.treas.gov/press/releases/hp1207.htm>; United States Department of the Treasury, TARP Capital Purchase Program, <http://www.treas.gov/press/releases/hp1207.htm> (follow "public term sheet" hyperlink) (last visited May 4, 2009) (describing program details).

<sup>3</sup> Pursuant to the LLP, Treasury will use Public-Private Investment Funds ("PPIFs") as purchase vehicles for troubled assets from FDIC-insured banks and will give private sector investors an opportunity to bid on up to 50% of the equity of each PPIF, allowing the winning bid to determine the market value of the asset. Federal Deposit Insurance Corporation, Legacy Loans Program—Program Description and Request for Comments, <http://www.fdic.gov/llp/progdsc.html> (last visited May 4, 2009).

has preliminarily considered some mechanisms to avoid this problem, including a requirement that investors retain some equity in the PPIF.

Bair additionally described some already implemented FDIC programs that she believed to be important, which include the \$250,000 temporary deposit insurance increase and the Temporary Liquidity Guarantee Program (“TLGP”).<sup>4</sup> She stated that the deposit insurance increase was very important from a public confidence standpoint and a consumer standpoint” because “there has been a flight to safety” by people—particularly retired individuals—who frequently have more than \$100,000 in FDIC-insured accounts. She stated that the FDIC instituted the TLGP—a temporary program in which the FDIC guarantees certain newly issued senior unsecured debt as well as provides limited coverage for non-interest bearing transaction accounts—pursuant to its systemic risk authority with the Federal Reserve and Treasury. Bair stated that the FDIC adopted the account coverage component of the program in response to the volatility in non-interest-bearing-transaction accounts last fall. Bair stated that “otherwise viable institutions [were] losing those accounts” and that this produced a “threat of having liquidity failures, which would have cost [the FDIC] a lot of money.” She concluded that for the time being, the TLGP has successfully stabilized those accounts. She stated that the debt guarantee portion of the TLGP has been successful: the FDIC has “had no losses” from the program, does not expect to have losses in the future, and has “actually collected over \$7 billion in premiums.” Bair stated that the FDIC has announced that it will be putting a surcharge on the debt guarantee portion of the program, that it “want[s] to get out” of the debt guarantee portion of the program, and that the program is scheduled to expire at the end of October 2009.

Bair next opined on proposals for future financial reform—including instituting a systemic regulator, creating a resolution authority for large institutions, reforming mandatory leverage ratios, and structuring the cross-border resolution of institutions—that the

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<sup>4</sup> See Federal Deposit Insurance Corporation, Temporary Liquidity Guarantee Program, <http://www.fdic.gov/regulations/resources/TLGP/index.html> (last visited May 4, 2009) (“The FDIC has created this program to strengthen confidence and encourage liquidity in the banking system by guaranteeing newly issued senior unsecured debt of banks, thrifts, and certain holding companies, and by providing full coverage of non-interest bearing deposit transaction accounts, regardless of dollar amount.”).

FDIC, Treasury, Federal Reserve, and the politicians on Capitol Hill have been debating.

On the proposal for creating a systemic regulator, she stated that the FDIC “is not opposed to the idea” and that “there could be some value added [in having such a regulator], but that it is not the magic bullet” because many of these institutions are already regulated. Bair stated that the value added of the systemic regulator would emerge from improving interagency collaboration and filling gaps in regulation in relation to the shadow-banking sector. However, she emphasized, “there is only so much regulators can do” for incredibly large and complex institutions.

Bair stated that a “more pressing” concern for Congress should be to create a resolution authority for large systemically significant institutions because this will “impose greater market discipline” on these institutions, which is “really what we need.” Bair stated that she would like creditors and investors to have “more scrutiny” of large systemically significant financial institutions because these institutions “for many years [have] benefitted from a perception of too big to fail and creditors and investors frankly have not done as much due diligence as they should when they committed their money to these institutions.” Bair stated that the current resolution structure is “not a practical process” because “[t]he FDIC cannot resolve a holding company, only the bank within the holding company . . . so you end up with two parallel structures, one for the FDIC resolution part and another for bankruptcy. And it just is not working.” She stated that a new resolution mechanism should set up “clear claim priority” in which “depository institutions, creditors, and investors will take some losses if the institution has to be resolved, [with] a fund that we can call upon, as opposed to having to go to taxpayers to absorb losses.” She stated the FDIC would be the logical agency to implement the large institution resolution mechanism: “We are not asking for it, but I think we know how to close institutions, we are equipped for it, and its cyclical work, so having multiple agencies’ staff for that task I do not think really is wise.” Bair added that there is much interest in having the FDIC take on that role and that it will continue to work with Congress to “see what can be accomplished.” She noted, however, “there need to be some strict firewalls between the funding mechanisms” of bank and non-bank components of the resolution mechanism if the FDIC receives the role of resolving any non-bank entities or subsidiaries because “obviously, we do not want the deposit insurance fund to be used to absorb losses associated with activities outside banks.”

In response to a question regarding the concern of removing judicial review process safeguards by moving the resolution of these institutions to a non-judicial agency, Bair stated that while the purpose of bankruptcy courts is to protect creditors of institutions, the purpose of resolving large systemically significant institutions should take into account the interests of the public and seek “to protect the deposit insurance fund, to protect depositors, to protect the systemic risk situation, [and] to protect the broader economy.” Because “very large financial institutions are unique in their capacity to negatively impact other parts of the economy” and “somebody has to pay” for their losses, Bair said the government must signal to the market that taxpayers will not continue to endure these losses in lieu of the creditors and shareholders.

Bair believes the world is moving in a positive direction in devising a workable international leverage ratio. She reaffirmed her beliefs in the shortcomings of the Basel II advanced approaches<sup>5</sup> but stated that she is “delighted that we are seeing increased support for an international leverage ratio,” which Bair stated people are actually calling “a supplementary capital standard.” Bair stated that the new ratio should be simple—“some hard, fast, easy to understand floor on excessive leverage”—and that “getting international agreement on this is really crucial.” She added, “the Basel Committee and the Financial Stability Forum are definitely moving in that direction,” which is “a very, very positive direction to go.”

Bair stated that “there is a lot more work to do” regarding the issue of cross-border resolution of institutions “that unfortunately has not been done.” Specifically, she noted the need for international agreement regarding the resolution process for very large or internationally active institutions. The FDIC has been co-chairing a subgroup on the Basel Committee to work on the cross-border resolution, and Bair stated, “We are really just scratching the surface in terms of arranging the types of agreements, dealing with reinvesting, and guaranteeing each other's liabilities.”

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<sup>5</sup> See Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Remarks to the Institute of International Bankers Annual Washington Conference (Mar. 2, 2009) (“I still have grave concerns about the [Basel II] advanced approach. The advanced approach assumes banks' internal, quantitative risk estimates are reliable. It also assumes the loss correlations we measured during good times ... which is the backbone of the whole approach ... will hold up in the future.”).

Bair concluded her remarks by opining that “we are past the crisis stage” and are “in the cleanup stage now.” She stated that the task is now to rebuild the broken financial system and “there are no quick fixes.” She stated that the goal of the reform would be to “to do it in an orderly fashion in a way that will minimize taxpayer exposure.” Bair concluded by stating that “everybody needs to be patient [because reforming the financial system is] not going to be pretty [but] we will just have to roll up our sleeves and do it.”

### ***III. First Panel Discussion: Reforming International Financial Architecture***

Dr. Jacob A. Frenkel, Chairman and CEO of the Group of Thirty (“G30”) served as the moderator for the Reforming International Financial Architecture Panel and discussed with three distinguished guests—Guillermo Ortiz Martinez, Governor of Banco de Mexico and Chairman of the Bank for International Settlements Board of Directors; Andrew Crockett, President of J.P. Morgan Chase International and Former Head of Bank for International Settlements; and Charles H. Dallara, Managing Director of The Institute of International Finance, Inc.—what the reformation of global financial architecture means today. Dr. Frenkel began by pointing out that the phrase “reforming international financial architecture” means “different things to different people at different points in time.” At the time of the Bretton Woods conference in the mid-1940s, it meant promoting the stability of trade and maybe stabilizing the Bretton Woods exchange rate system. It subsequently meant choosing between fixed or flexible exchange rate regimes and fine-tuning institutional settings to promote the functioning of these regimes. Later, it meant choosing between regimes of open or controlled movements of international capital. Twenty years ago, it meant “international [fiscal] policy coordination.” Dr. Frenkel stated that today the phrase implies much more of a focus on issues of regulation and supervision, since “the main links [of globalization] internationally today operate through the financial system.” He noted that the G30 recently released two types of major reports, one of which provides “comparative examinations of seventeen markets”<sup>6</sup> and the other one of which “again focuses on these types of matters and draws the distinction between systemically important institutions

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<sup>6</sup> GROUP OF THIRTY, *THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE* (2008).

and systemically less important institutions, highlighting the question of risk management, governance, coordination, and the like.”<sup>7</sup>

#### A. Guillermo Ortiz Martinez

Martinez began the discussion, addressing points regarding international financial cooperation that emerged from the G-20 Summit on Financial Markets and the World Economy in London on April 2, 2009, IMF corporate governance reform, and some additional points regarding pressing financial regulatory reform.

Martinez believes “that there was real progress at the London summit.” He cited as “some of the very concrete points that came out” of the summit reform ideas such as tripling the resources of the International Monetary Fund (“IMF”) from \$250 billion to \$750 billion as well as the emerging “support for the creation of a flexible [IMF] credit line.” Martinez stated that this reform is important to a number of countries, including Mexico (his own country), Poland and Colombia, who have all utilized the IMF credit line.

Martinez next addressed IMF corporate governance reform, stating that the present system is wholly inadequate and describing some recommendations that emerged from the Committee on IMF Governance Reform report.<sup>8</sup> The reform group chaired by Trevor Manuel, Minister of Finance of the Republic of South Africa, of which Martinez was a member, wrote the report. Martinez stated that “we have to make a lot of progress in terms of governance” because “the present governance arrangements in terms of international corporations have failed miserably, [and that] these arrangements can no longer be trusted to run the world economy.” Martinez stressed the points of reform that emerged from the IMF report,<sup>9</sup> including the “crucial” need for the “re-composition of the IMF Executive Board to reflect current market realities” by allowing China and emerging market economies a presence on the board, “consolidation of chairs, including those of the European Union,” lowering the voting threshold on critical decisions from 85% to 75%, and the amendment of the IMF Articles to endure “an open and Democratic election” of

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<sup>7</sup> GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY (2009), *available at* <http://www.group30.org/pubs/reformreport.pdf>.

<sup>8</sup> COMMITTEE ON IMF GOVERNANCE REFORM, FINAL REPORT (2009), *available at* <http://www.imf.org/external/np/omd/2009/govref/032409.pdf>.

<sup>9</sup> *Id.*

the Executive Directors. He stated that such “governance arrangements are fundamental for the conduct of surveillance” because “a massive failure of the instances of international cooperation” exists today. Martinez concluded this point by stating that to see progress, there needs to be “a political will to use these new governance arrangements in order to prevent the types of imbalances that led to the crisis in the first place.”

Martinez next addressed three salient areas for much-needed regulatory reform: supervision of global banks, cross-border crisis resolution, and regulation of over-the-counter (“OTC”) derivatives. Martinez stated that while there is largely international agreement regarding the need to “set up supervisory colleges for the largest and [most] systematic[ly significant] international banks,” which is a “crucial step,” the logistics of regulating such institutions are challenging. Using Scotia Bank in Canada as an example, Martinez demonstrated the difficulty of coordinating such regulation: “The Canadian authorities decided that they did not need a college of supervisors for Scotia Bank. Now, Scotia Bank is the largest bank in Costa Rica, the third largest bank in Peru and the seventh largest bank in Chile and Mexico.” He stated that because “home country supervisors” are the ones deciding to set up supervisory colleges and these large institutions span different countries, in order for the colleges to be effective they must be “manageable,” “inclusive,” and must account for the needs of other countries in regulating these banks. Because “we have a global financial system” yet “each legal framework ends at national borders” and “financial authorities look only at the entities legally established in their jurisdictions and not at the networks or interlinked entities,” Martinez also believes that a cross-border crisis resolution system is necessary.

Martinez likewise believes that because OTC derivatives function in the internationally active financial markets, the lack of regulation for these instruments is concerning. He stated that “the lack of transparency” in the market for these derivatives increases the level of uncertainty, which, as the failure of American International Group, Inc. (“AIG”) and the losses of several Mexican, Brazilian, and particularly Korean corporations show, leads to problems. Martinez believed that both the corporations and the investment banks were to blame for these losses. Corporations suffered losses because “despite the fact that the financial system was in good shape, corporations engaged in derivative transactions which produced huge amounts of losses and in many cases had nothing to do with the businesses that these companies were involved in,” said Martinez. He

added that “it is also highly unethical and irresponsible on the part of investment banks that sold . . . these very toxic products” because they ran such a complex operation that these banks and their Chief Financial Officers themselves “did not really have a clue about what they were doing.”

### **B. Andrew Crockett**

In response to Dr. Frenkel’s introductory remarks regarding the meaning of financial architecture, Andrew Crockett began by defining what “global financial architecture” means to him at this point in history: both the “broad model of international financial regulations that is endorsed by the international community” and “the network of institutions that it set up to manage and oversee that model.” Because “now we have a system in which we acknowledge that markets are there to be the primary allocator of resources, where capital can flow across international boundaries, and where the financial industry is global [such that] both markets and institutions can spread across different boundaries,” Crockett stated, we have seen market failures occur. Crockett added that although, “the present crisis is eloquent testimony to the shortcomings of a market-based model . . . , nobody pretends that you should therefore retreat from that model.” Rather, the consensus is that the goals are to strengthen and improve the current system. Crockett opined that the second part of “architecture”—the creation of networks of institutions—is thus critical in this area to manage market failure so “that we can avoid the kind of crisis we are in now.” Consequently, Crockett focused his discussion on ways in which regulators and organizations can reform the market-based financial system to make it more stable.

Crockett believes that when forming international financial regulatory structures, it is “helpful to think in terms of the functions that need to be performed by the bodies set up to exercise oversight and match those functions to the bodies that we have” rather than creating “brand new financial international institutions.” He stated that setting up new institutions is both unrealistic and unnecessary because of the “plethora” of such institutions that already exist today. Crockett proceeded with his presentation in just this manner: describing the functions that international regulatory and supervisory bodies need to perform in order to ensure the smooth functioning of a market based system—those of rulemaking, oversight, enforcement, and crisis resolution—and matching currently existing institutions

with the functions he believed each institution would perform best. He stated that although we essentially have national regulation and “we will not have in the foreseeable future a global financial authority,” global regulation could occur through “mechanisms of international cooperation,” much like existing mechanisms and institutions such as for example the Basel Committee, the International Association of Insurance Supervisors (“IAIS”), the IMF, the G-20, and the Financial Stability Board (“FSB”). He also noted that it is primarily important to close the gaps in responsibility when delegating supervisory tasks and to avoid overlaps in responsibility.

Regarding the rulemaking function, Crockett believes that the rulemaking body should regulate large and systemically important institutions to ensure that they are stable. He stated that this function should “remain the province of the specialized bodies of international regulation” and that the Basel Committee is probably the best for the job. Crockett noted, however, that the Basel Committee could use some improvement “in its representativeness” and in adopting “a more macro-prudential as opposed to micro-prudential approach.” He added also that the rulemaking body needs to be “strengthened in such a way that they have more force with national regulators who have to do the enforcement.”

Crockett stated that a body that has the capacity to assess and identify “points of vulnerability” in the financial system “before they reach a stage at which they are systemically threatening” must perform the oversight function. Crockett suggested giving the FSB the oversight role of “reviewing regulations that are put out by individual bodies of regulators to verify that the essentially micro-prudential perspective of sectoral regulation is consistent with overall financial stability.” He presented as an example for the need of this role certain Basel II capital rules,<sup>10</sup> which “had a strong logic within the confines of what they were attempting to achieve but, in fact, contributed to systemic vulnerability by creating incentives for the institutions or the auditors that were regulated to act in ways that could generate systemic problems.” One of the reasons Crockett believes the FSB would successfully carry out this role is that the FSB broadly includes “key stakeholders” and typically is composed

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<sup>10</sup> See generally BASEL COMMITTEE ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS: A REVISED FRAMEWORK (2004), available at <http://www.bis.org/publ/bcbs107.pdf?noframes=1>.

of senior finance ministers. He wittingly noted, however, that the FSB was originally headed by the seven leaders of the G-7 countries and largely functioned under the assumption that “financial crises were things that happened elsewhere in the world and could only be resolved by the wisdom of the industrial countries. Now they have realized that perhaps a broader approach is necessary.” Additionally, Crockett noted that overseeing microeconomic imbalances that grow to create large problems is an obvious role for the IMF, although it “has always been active in analyzing and expounding on those issues but never really had the force or power, particularly with the major countries, to make sure that its recommendations are adopted.” Crockett stated that the key message regarding oversight, therefore, is granting the overseer “a greater degree of authority” and giving the IMF “more power to act as an international referee” in terms of macroeconomic policies.

Crockett envisions that an enforcement mechanism is necessary to adequately control large systemically important institutions and he believes it could only function at the national level. He stated, however, that “it is important for there to be some consistency of enforcement across national boundaries,” and so a body such as the FSB “could be a useful forum for information sharing and encouragement towards consistent enforcement.”

Crockett stated that the crisis resolution regulation, like enforcement, is likely to remain at the national level and involve primarily national authorities, at least in the major countries, because consistency in resolution approaches is not a top priority. Crockett believes that sharing of information among nations would enable greater harmonization of the resolution processes, but that home resolution policies, even though they may have implications on other countries, are not a place where international decisions will take place.

One final point of reform Crockett noted concerned procyclicality. He stated that, “undoubtedly, there is natural procyclicality in the financial system” and certain rules, such as for example Basel II (although Crockett believed the criticisms can sometimes be exaggerated in that respect), can add to that procyclicality. Crockett stated that, as was emphasized in the G-20 communiqués, “regulation of the financial system must be designed in such a way as to combat procyclicality.” He stated that while “the principle is relatively obvious”—adopting systems where “banks can be encouraged to build up capital cushions in good times so that they are available to run down in bad times”—the implementation and

“technicalities” of the procyclicality reform proposals will not be straightforward.

### C. Charles H. Dallara

Charles H. Dallara discussed both areas that require urgent global action and less pressing but nevertheless important areas in need of architectural reform. The three areas in which Dallara saw a need for urgent action are dealing with toxic assets, mobilizing resources for banks, and fiscal stimulus for struggling countries. He stated that although these urgent matters may not neatly fit into the category of “architecture” reform, he felt that it was necessary to address them because “we are running a risk of some complacency about addressing the current stress in the global economy.”

Dallara believes that the U.S., Europe, and the rest of the world are “running a serious risk of a further period of instability” by cleansing bank balance sheets of toxic assets in a “time-consuming and indirect fashion.” He stated that the removal of toxic assets needs to be completed “before the new round of bad assets arrives as the result of the global recession.”

Secondly, Dallara stated that there is an urgent need to mobilize resources for the IMF, the World Bank Group (“World Bank”) and the regional banks. He congratulated the IMF for creating its credit line and congratulated Mexico on the leadership it has shown by its willingness to initiate utilization of it. He also warned that failing to “quickly to augment the funds of the IMF” would cause “these credit line activations . . . to drain available resources of the IMF quite quickly.”

The third area for urgent action to which Dallara pointed to was fiscal stimulus, which he stated must come from leaders of the global economy because certain countries are not themselves fiscally robust enough to stimulate their own economies, giving Mexico, Brazil, and Turkey as examples of such countries.

Dallara then went on to directly address the topic of global regulatory architecture while highlighting the problems of global cooperation and the necessity of IMF reformation.

In the area of global coordination, Dallara discusses three issues—lack of prioritization of global regulation, government intervention, and the deleveraging process—that he believes reform attempts need to address.

Dallara stated that because it is simple to focus on regulatory action at home rather than prioritize global regulatory coordination,

measures taken domestically in attempts to remedy problems that impact countries globally “have a real risk of fragmenting global regulatory standards at the very time we need to globalize and harmonize them.” He provided liquidity proposals in the United Kingdom as the prime example of this phenomenon.

On the subject of government intervention, Dallara stated that while capital injections initially helped to stabilize the system, “the legacy of those actions is troubling” because “often attached to the government capital injections have been messages, ‘keep the money at home,’ ‘keep the credit at home,’ ‘keep the capital at home,’ . . . [which] is dangerous in a world in which we have globalized banking.” Governments attach such conditions because they believe that taxpayer money should remain in its home country, yet such conditions are incompatible with a globalized financial system.

Thirdly, Dellara stated that the deleveraging process, which is itself a market-driven force, needs additional regulation on a global level. He discussed the “need to harmonize [regulatory and supervisory] practices around the world” and either greatly empower the FSB to do this task or create an organization “under the umbrella” of the FSB that can work with the IMF to accomplish that task.

Concluding with the topic of IMF reform, Dallara stated that he has much support for the IMF Governance Reform that Martinez discussed. He noted that “it is important that the voting structure of the IMF be adapted to the reality of today's global economy” because the current structure in which Belgium’s voting shares are equal to or surpass those of China is, in his mind, anachronistic and should have been changed years ago. Dallara stated also that unless the major shareholders of the IMF, including the U.S. and China, “are prepared to subject their macro policies to a global process of coordination through a multilateral surveillance process that has some teeth, then we are unfortunately bound to evolve in a world where again global imbalances feed a global crisis,” as happened this time. These imbalances, Dallara added, included an almost seven percent deficit in the U.S. and an almost eleven percent surplus in China, which further contributed to global instability.

#### ***IV. Second Panel Discussion: Restructuring and Reforming U.S. Regulatory Agencies and Responsibilities***

Robert R. Bench, Senior Fellow of the Morin Center For Banking and Financial Law at Boston University School of Law, the

moderator for the second panel, called on the panel—comprised of John Dugan, Controller of the Currency of the Office of the Controller of the Currency (“OCC”); Robert Kelly, Chairman and Chief Executive Officer of the Bank of New York Mellon; and James Leach, Professor at the Woodrow Wilson School at Princeton University and Former Chairman of the House Financial Services and International Affairs Committees—to discuss the critical elements of effective reform in the U.S., and the panelists proceeded to do so, in alphabetical order.

#### **A. John Dugan**

The five main areas that John Dugan believes merit reform are the prevention of excessive systemic risk, the closing of systemically important institutions, consolidation of regulatory agencies, improvement of loan underwriting standards, and making loan loss reserves more countercyclical.

In the area of excessive systemic risk management Dugan opined that a systemic risk regulator is necessary. He stated that the Federal Reserve already performs that role for banks and that this crisis has shown how such a regulator could be helpful for non-banks, as evidenced for example by problems at Bear Stearns, Lehman Brothers, the Federal National Mortgage Association (“Fannie Mae”), the Federal Home Loan Mortgage Corporation (“Freddie Mac”) and AIG. Dugan believes that the Federal Reserve is the logical choice for a systemic regulator. He added that the role of the systemic regulator must be expanded to oversee “all systemically significant financial companies . . . including the banks that we supervise,” and that “there is a consensus [that we need] stronger capital requirements, stronger liquidity requirements, better transparency and management of off-balance-sheet risk, among other things.” Dugan stated that while there is also a consensus that capital requirements need to be increased, this is not something that can be done now, in the middle of a recession, “but there clearly is going to be an effort to make changes going forward.” Dugan also believes that it is necessary to impose “better regulation and risk management of complex financial products, many of which were at the heart of huge losses that we experienced in the system.” Regulation of these products would involve “more clearinghouses for standardized derivative products and enhanced supervision of the more customized products like credit default swaps that do not neatly work on an exchange.”

On the issue of failing systemically important institutions (those that are “too big to fail”), Dugan stated that because it is impossible to “eliminate the systemic risk exception or to eliminate entirely ‘too big to fail’ from the system,” it is necessary both to minimize the likelihood of systemically important institution failures and to reform the Federal Bankruptcy Code regime to better handle such failures when they do occur. He stated that the best way to address “too big to fail” is to “take steps to reduce the likelihood that you have a failure in the first instance of a systemically important company,” but that of course this is not always possible. Dugan added an important note regarding preserving government power to act in these tough situations:

I do not think we should ever tie the government’s hands from taking extraordinary measures to protect the system and to take measures of the kind that we took last year. We should do everything we can to make those occasions much less likely, but we should never take away an ability to do that.

Dugan stated that “we need a better regime than the Federal Bankruptcy Code” and we should model reform after the FDIC bank resolution regime. As the advantages of the FDIC regime over the Bankruptcy Code procedure Dugan noted “the pot of money” that is available, which can “facilitate acquisitions of distressed or failing companies by healthier companies,” and “the so-called systemic risk exception that allows for extraordinary actions to be taken other than the normal insolvency regime to prevent or do different things in connection with a failure that would cause systemic damage.” He stated, however, that he has concerns regarding granting the FDIC the same type of resolution authority for non-bank institutions as it currently has for banks because while the “FDIC has considerable expertise in resolving and winding down companies that fail, including larger institutions,” it does not “have very much experience in running large institutions, which is what can be required with a systemically important company when it gets into trouble.” Dugan believes that many other agencies would need to get involved in resolving non-bank institutions. He noted that if the system of FDIC resolution of non-bank institutions were in place last year, today the FDIC would be running AIG, Fannie Mae, Freddie Mac, Lehman Brothers and possibly Bear Stearns, which would not be a viable situation.

Dugan stated that the consolidation of regulatory agencies is necessary in light of the existence of four federal banking regulators, twelve Federal Reserve banks with overlapping responsibilities, and fifty state bank regulators. To highlight the consensus regarding the need for this reform, Dugan quoted the often-utilized expression describing the U.S. banking regulation as “a system that does not work at all in theory, but [one that] we have managed to make work in practice.” While Dugan does not believe that the overlap in responsibility caused the financial crisis, he does believe that “this is the first real opportunity in a very long time to streamline and make more sense of this process.” Dugan offered several guiding principles to structure such reform, including preserving some sort of supervisory role for the Federal Reserve, as well as retaining a “dedicated prudential supervisor,” the sole responsibility of which is supervision so that it is “not distracted by other responsibilities like monetary policy, macroeconomic supervision, or deposit insurance.” He stated that this type of system is desirable because it “creates clear lines of responsibility and clear accountability.” Dugan then focused on the main problem with instituting the consolidation, which is resistance from agencies that will be eliminated or lose power in the consolidation process: “The age-old problem with the consensus . . . is the age-old problem with heaven: everybody wants to go there, but nobody wants to die.” However, Dugan is hopeful that this crisis will present the opportunity for such reform to finally take place.

Dugan next stated the need to improve loan-underwriting standards, especially for mortgage loans. He stated that mortgage lending must “return to the basics” with respect to down payments and income verification. Maintaining a more stringent loan-to-value ratio, for example, has helped Canada fare better than the U.S. through the crisis, he noted. He added that, “of course, if you move to that system you have to accept what it means, which is fewer people will qualify for mortgages and those that do will qualify for smaller ones, but that is unavoidable from having more, better prudential standards.” Secondly, Dugan stated that it is important to maintain consistent mortgage lending standards irrespective of the source of mortgage origination, which has not been the case recently in the U.S. He described three mortgage underwriting regimes in the U.S. in the order of most to least stringent: first, the national and state banks; second, bank holding company affiliates of banks; and third, companies that are unaffiliated in any manner with banks. The difference in standards came from the variation in the manner in

which these underwriters were regulated, with banks being closely supervised on the national and state level on one extreme and with unaffiliated companies receiving no supervision, and thus turning primarily into what Dugan termed a market-driven “licensing regime” for lending, on the other. Dugan stated that “these differences in regulation resulted in three very different standards, which put pressure on the most regulated [entities and] led generally to a decline and erosion of underwriting standards.” He added, however, that uniting these standards is “a very hard problem to solve” because non-bank entities that lack “an examination and supervision culture” may not be susceptible to the same type of supervision. Lastly, Dugan stated that both mortgage and non-mortgage “lenders should have comparable underwriting standards for loans that they sell that are the same as the loans that they hold on their books.”

The fifth point Dugan stressed was that loan loss reserves should be much more countercyclical. He stated that the problem today is that

the so-called impaired-loss model effectively limits the amount of loan loss reserves that a bank can take or create when times are good, especially in a long period of economic growth when the historical records show very low loan losses. [This] means that we as regulators cannot start making banks significantly increase reserves and take losses . . . until a recession is upon us.

He stated that banks should build reserves in a “much more forward-leaning” fashion so that they have a cushion on which to rely in bad economic times.

In response to an audience question regarding the use of a tangible common equity (“TCE”) ratio in formulating the new stress test, Dugan stated that there is an international consensus that the quality of capital used in the ratios needs to be improved, although he declined to comment on the type of ratio that will ultimately be incorporated in a new stress test because it is a work in progress at the moment.

## **B. Robert Kelly**

Robert Kelly began by agreeing with Dugan on his point regarding consolidation of regulators. He stated that the rest of the world has one or two regulators, and that “we have an antiquated system that needs to be modernized.” To him, “[the inertia of the current regulatory structure] is not rocket science” but rather a “political difficulty” that this country can get past. The purpose of this consolidation should be, Kelly stated, primarily increasing accountability, rather than considerations of efficiency and cost. Reducing the number of regulators will stop the passing of the blame and force regulators to take responsibility for their failures, while helping retain “the best and the brightest” people working for regulators.

Kelly continued by addressing additional points of reform he considered to be important, including the need for a national insurance regulator, a systemic regulator, a reformation of the mortgage process, the need for global accounting standards, the improvement of oversight of credit rating agencies (“CRAs”), improving capital standards, and creating a centralized clearing system for derivatives.

The need for a national insurance regulator and a systemic regulator stems from considerations of accountability and standardization. Kelly stated that “substantially similar activities, with substantially similar risk, should basically be supervised in substantially similar ways” so banks and insurance companies should be subject to the same regulation as other entities who perform similar activities.

Kelly also stated strongly that the mortgage process “does not work in this country. It is totally broken, and it needs to be fixed and . . . fundamentally rethought.” He stated that the features and pricing of U.S. mortgages is inadequate and that the U.S. is the only country in the world that had Government-Sponsored Enterprises (“GSEs”) for mortgages that create large and unreasonable amounts of risk for taxpayers and investors. Kelly said that there is much room for improvement because “we have provided homeowners huge benefits in this country at a big cost to the nation . . . and from a policy perspective have not ended up with higher ownership rates.” Stating that perhaps the U.S. should look to the models of other countries for reform, Kelly agreed with Dugan that the Canadian mortgage system has fared much better through the crisis, with Canadian banks only losing up to ten basis points on mortgages, and

that the country's respect for mortgage underwriting fundamentals, its lack of GSEs, and holding mortgages on the originators' balance sheets have all contributed to this result. He stated that a national standard for mortgage underwriting would be a positive improvement for the country.

Kelly sees a need for a global accounting standard in light of the global nature of our financial system. He also agreed with Dugan that there needs to be procyclical accounting and that the OCC or the Federal Reserve should take on the supervisory role with respect to that.

Kelly spoke about the need to improve the oversight of and confidence in CRAs. In order to revitalize the securitization market, Kelly believes it is crucial to restore confidence in CRA ratings. He believes that CRAs should be regulated "under the umbrella of the systemic regulator" and subject to regulatory oversight to accomplish this goal.

In conclusion, Kelly stated that the concerns regarding the "too big to fail" doctrine should be addressed through reforming capital standards and forming clearinghouses for derivatives. Liquidity standards, in addition to capital standards, are very important, Kelly stated, as it was over-leveraging that exacerbated the recent financial problems: "Banks did not disappear last year because of capital; it was because of liquidity issues." He added that clearing houses for derivatives would impose additional controls to reduce "too big to fail" concerns.

Following Dugan in responding to the TCE question, Kelly stated that using TCE is superior to using Tier 1 capital and that the TCE is really what the market cares about, although a problem with its use are that the measure is very procyclical and overly simplistic.

### **C. James Leach**

James Leach stated that different analytical frameworks create different ways of looking at the problems in the financial system, and he presented his ideas through three frameworks—philosophical, regulatory, and leadership judgment—for banking analysis.

From the philosophical perspective, Leach clarified that deregulation of the financial industry was a myth and that the majority of political and regulatory leadership was in fact in favor of Gramm-Leach-Bliley Act reform. He stated that not only was the Glass-Steagall Act never repealed, the Gramm-Leach-Bliley Act in

fact increased the regulatory framework. He explained that while the change in regulation allowed the three areas of Glass-Steagall regulated industries—insurance, investment banking, and commercial banking—to compete against each other, the regulatory framework remained the same, with some additions. Those additions included giving the Federal Reserve the power to oversee certain financial holding companies and giving the Securities and Exchange Commission (“SEC”) specific authority over investment banks and holding companies for the first time.

From the regulatory perspective, Leach discussed dual banking. Leach described the dual banking system as one the establishment of which “is surprisingly rooted in history [and] surprisingly rooted in a relative amount of rationality.” He stated that although the banking system may be bifurcated to too large a degree, the bifurcation is on the state to federal level. All of the reform is occurring on the federal level, he added, and nobody in Washington D.C. is talking about reforming the duality of banking. Leach stated that the states have “maintained the basics” in banking regulation and consequently look extraordinarily prudent. He stressed that the “issue is not liquidity, it is real capital” and maintaining lower leverage ratios is desirable because it “maintains a buffer for emergencies” and constrains excessive growth. “It is the lure of leveraging which has really caused the dilemma we are in more than people might suspect,” Leach added.

In terms of leadership, Leach opined that it is important for the U.S. to maintain both an internationally and domestically competitive banking system. Maintaining competitive systems, however, does not involve sanctioning imprudent practices. Leach stated that mistakes in judgment in this regard were the key pitfalls of U.S. regulators, who, for example, used international Basel II standards and applied them only to the largest institutions. In retrospect, Leach summarized, “it is not that we are learning new things,” since everybody knew at the time it was happening that too much borrowing and too little trade creates twin deficits that will eventually cause problems, that CRAs had financial conflicts of interest, and that a certain amount of mortgage fraud was occurring. He concluded by noting that more right-brained people as opposed to left-brained people—scientifically-minded versus linguistically-minded individuals—should be placed in charge of making critical decisions regarding financial regulation and operation of financial institutions.

In responding to the TCE question that Dugan and Kelly addressed, Leach likewise agreed that TCE is a superior measure to Tier 1 and “the notion that we are returning to TCE is common sense,” since “Tier 1 capital” includes debt, which is clearly different from capital.

**V. *Third Panel Discussion: New Policies or Policy Enhancements for Assuring Financial Stability***

Richard Spillenkothen, Director of Deloitte & Touche, L.L.P. and the moderator for the third panel, engaged his panelists—Jerry Hawke, partner at the law firm Arnold & Porter, LLP and Former Controller of the Currency in the Office of the Comptroller of the Currency; Richard H. Neiman, Superintendent of Banks at the New York State Banking Department; Gary H. Stern, President of the Federal Reserve Bank of Minneapolis; and Richard Whiting, Executive Director and Chief Counsel as the Financial Services Roundtable—in a question-and-answer-format discussion on matters of financial policy reform.

**A. *Key Problems with the U.S. Regulatory System***

In response to Richard Spillenkothen’s inquiry about the key problems with the U.S. banking system, the panelists largely agreed that while the presence of certain regulations did not cause the crisis, the absence of appropriate regulation in certain areas contributed to the problem, and that perverse incentives—based on the compensation structures of various market participants—were to blame for the crisis.

Jerry Hawke began by agreeing with Leach and emphasizing that deregulation “had absolutely no role in causing the present crisis.” He stated that no significant Gramm-Leach-Bliley merger activity occurred past the Citicorp acquisition of Travelers Group, Inc. and added that, in fact, investment banking and insurance companies became bank holding companies at the height of the crisis so as to be subject to federal regulation, forming “a paradox that Gramm-Leach-Bliley became useful only in the context of helping us to deal with the crisis.” While Hawke stated that regulators surely have some part of the blame regarding mortgage failure, “the real cause of the present crisis was the role of the investment bankers and the roles of securitization.” He stated that artificial top-down demand—where securitization demand feeds underwriting, as

opposed to the standard bottom-up demand with people seeking housing loans to fuel underwriting demand—increased market risk by diluting underwriting standards.

Gary H. Stern believes that the combination of perverse financial incentives and a lack of preparation for the ultimate foreseeable failure of the system contributed to the problem. Stern stated that “uninsured creditors of large complex institutions had at most modest incentives to pay attention to the condition and prospects of those institutions, because of the “too big to fail” precedents that were already in place and because of their understanding of the motivations of policymakers when things that destabilized the system occurred,” which led to limited market discipline, misplaced and underpriced risk. Because the incentives were identifiable and in fact were identified *ex ante*, Stern said, regulators could be partially blamed for the lack of appropriate preparation for this foreseeable problem. On expectations regarding mortgages, Stern noted that there were “widespread expectations across the country that housing prices could only go up over time,” and that “without that expectation, a lot of these deals would not have been done.” He added that mortgage deals were also conducted based on the expectation that refinancing within one to three years will always be an available option, which was also partially erroneous.

Richard Whiting agreed with Hawke and Leach that Gramm-Leach-Bliley was not part of the problem and stated that in fact it provided a solution in its aid in dealing with struggling investment banks by allowing them to affiliate with stronger commercial banks. Whiting stated that the financial services industry must take part of the blame because of its engagement in imprudent practices and offering of perverse incentives through its compensation packaging structure. He stated that the regulatory failure stemmed from gaps in regulation of certain activities, such as “the securitization market, [where] there was no one from the beginning to the end who looked at that [market] and what the impacts would be [on the system as a whole]”—and that the policy changes should strive to fill these gaps.

Richard H. Neiman stated that the problem began very early on in the area of mortgage brokerage and in the movement away from a focus on origination toward a focus on securitization. Neiman stated that the misaligned incentives, including higher mortgage broker compensation for originating riskier, high-yielding instruments, and the “lack of due diligence at all levels of the process from the mortgage broker to the mortgage banker” created the

problem. He stated that reform should focus on the many entities that caused the crisis, including re-examining the securitization process, dealing with appropriately assigning risk, and examining the conflicts of interest of CRAs.

### **B. Major Obstacles to Regulatory Restructuring and Reform**

Spillenkothen next asked the panelists to discuss the major obstacles to regulatory restructuring and reform. The panelists proceeded to debate ideas regarding dual banking and consolidation, largely coming to a consensus that states have done a good job instituting prudential regulations and that some type of federal regulatory restructuring is necessary.

Hawke stated that he is not convinced that regulatory restructuring is necessary—both because the dual banking system works quite well and because the multiplicity of agencies had nothing to do with the crisis—and proceeded to describe the obstacles to regulatory consolidation. He stated that consolidation of regulatory agencies would be difficult because of, as Leach pointed out, the perception of state bank supervisors that federal consolidation is a threat to dual banking. He also stated that the role of the Federal Reserve is a crucial and unresolved issue, and that there are obstacles due to the historic ability of the Federal Reserve to scuttle any proposals for consolidation that either involve it or take away certain powers from it. He also stated that the funding for the new consolidated agency would be a problem. Because the national bank supervisor currently is funded by assessments from the banks it supervises, the federal supervisor of state member banks receives funding from the Federal Reserve, and state supervisors receive funding from both state bank assessments and federal subsidies from the Federal Reserve and the FDIC, Hawke stated that disparate treatment of state and national banks in terms of assessments would present large problems. He clarified that “taking away that subsidy that state banks presently enjoy which would be politically difficult [and that] the alternative of course would be subjecting this new consolidated agency to the appropriations process.” He stated that the appropriations process route is not a great idea because it would involve inviting “a new dimension of political involvement” into the banking system.

Neiman believes that federalism and the role of states is important and that reformers should use the great history of the dual

banking system to design appropriate reform rather than start with a clean slate. Neiman stated that he has gained an appreciation for the dual banking system and that he is concerned that the federal consolidation portion of the restructuring proposal of Timothy F. Geithner, Secretary of the Treasury, is unclear regarding the continued role for states, especially in the realm of chartering and prudential supervision. Neiman stated that it sounds as though the issue of the role of states is still open, since Geithner told Neiman that there would be a state role but declined to comment further. He stated that “cooperative federalism” is important because states are in the best position to identify issues up close and that states should therefore retain the role of oversight and prudential supervision, especially with respect to small community banks. He also stated that states are able to react more quickly as they are more familiar with certain issues, and that “[the banking system] really need[s] more cops on the beat, not less.” Additionally Neiman believes that there is a role for states, particularly states like New York, in wholesale supervision of institutions. He believes that “the model of being able to leverage the resources of the state” with state regulatory partnerships, with the Federal Reserve acting as the primary regulator, would fit well as the new regulatory structure.

Stern stated that while he agreed that the structure of the regulatory system did not cause the crisis, the system should nevertheless be reexamined to the “most effective way to supervise and regulate the institutions we want to subject to these rules and regulations and oversight.” He added also that the Federal Reserve should be involved in some way because it is the only overnight short-run source of liquidity.

Whiting stated that the existence of “many agencies and parties with embedded interests,” unlike in the times of the Franklin D. Roosevelt era, makes it more difficult to make changes. He stated the need for a federal insurance regulator because there are many parallels to the banking system that could be advantageous. He added in conclusion that there does not need to be a separate consumer-regulating agency because banks have done a good job regulating in that area and “their approach, which is a prudential regulatory approach, is one that works and is very effective.”

### **C. The “Too Big to Fail” Doctrine**

There was unanimous agreement among the panelists that instances of the “too big to fail” doctrine—government bailouts of

large systemically significant institutions—are inevitable and will at one time or another occur to prevent systemic disruption. The panel provided some recommendations and frameworks for analysis of this issue.

Stern noted that “too big to fail” is the subject of the recently released book he co-authored,<sup>11</sup> and then proceeded to highlight the main points regarding the debate. He stated that it is important to analyze the policymakers’ motivations for protecting creditors and to ensure that those concerns are met in order to reduce government bailouts under the “too big to fail” heading. Stern stated that those motivations mainly derive from the spillover effects of failing institutions: “Large complex institution will ultimately affect many other institutions and markets and the real economy as well.” He stated first that to make policymakers confident that intervention is unnecessary, it is important to “identify and limit” the spillover effects “in tranquil times,” a recommendation that is similar to that which appears in the G30 report.<sup>12</sup> Stern suggested the following: “Look at exposures among large institutions, look at what markets they are particularly critical in, [and] ask yourself are those exposures reasonable, or do you need to act in a supervisory way to do something about that? What kinds of exposures do they have to counter parties?” Secondly, Stern stated that it is necessary to improve prompt corrective action by enhancing market signals to create some type of accounting. In addition, he stated that any changes must be communicated broadly, especially to uninsured creditors, so that they can react accordingly. Finally, Stern stated that it is critical to “improve [the] market discipline of these institutions along the way” by increasing capital, installing more liquidity buffers, and overall engaging in “traditional supervision and regulation.” He stressed that there will always be instances in which government intervention will still make sense and “eliminat[ing] ‘too big to fail’ for all time and all circumstances” is not something he expects will occur.

Hawke pointed out that the “too big to fail” debate arises usually at times “when an institution is on the brink of failure” and otherwise remains unaddressed. He stated by way of example that when he worked at the Treasury in the middle 1990’s Congress asked the Treasury to consider the feasibility of privatizing Fannie Mae, a

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<sup>11</sup> GARY STERN, RON FELDMAN & PAUL A. VOLCKER, *TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS* (2009).

<sup>12</sup> GROUP OF THIRTY, *supra* note 7.

proposal that received a lot of political resistance at a time when the country was in stable financial condition. “If Fannie Mae had been privatized, if steps had been taken to dispel the assumption that the government would stand behind their liabilities, we might have done something very constructive,” he added. He continued that often in “too big to fail” discussions, “there is an implicit assumption that that failure means that all liability holders get wiped out,” but in fact experience with FDIC-administered bank failures shows that uninsured depositors recover a large portion of their debt. Hawke strongly endorsed Stern’s point regarding prompt corrective action, stating that “the genius” of the idea is that, if it is administered promptly and effectively, such action offers uninsured creditors large protections against loss of value. He stated that “prompt corrective action . . . is based on the notion that as capital falls there should be increasing intervention on the part of the regulators with increasing pressure to force recapitalization or mergers before real capital runs out,” and that its success is based on accurately measuring capital and the quickness of its administration. Hawke stated that regulators egregiously failed to accurately measure capital in recent years, but that if prompt corrective action is well administered in the future, it will provide strong protections against the “too big to fail” issue.

Neiman pointed out that the U.S. regulatory environment has shifted dramatically from an emphasis on expanding U.S. banks so that they can effectively compete with other large European and other foreign banks to one where there is a concern about the large size and consequent unmanageability of banks. He also noted that there would be an emphasis on internal controls—risk management and governance—going forward.

Whiting stated that instances of an entity being “too big to fail” will never really be eliminated and that they are something that needs to occur in order to prevent large systemic disruption.

#### **D. Function of the Systemic Risk Supervisor**

Because a consensus emerged throughout the discussion regarding the necessity of designating a systemic risk authority, Spillenkothen asked the panelists to comment on the functions of such a regulator.

Stern began by stating that a poorly executed installation of a systemic regulator “could potentially make things worse by extending moral hazard and all the perverse incentives that go with that.” He stated that the supervisor would presumably “rely on the

so-called consolidated supervisors across various industries for the bulk of the work” and that its main function would be to judge the amount of risk and intervene in cases where it believes actions are occurring too slowly, for example. He stressed that it is very important for the supervisor to have a large amount of authority to supersede and override the actions of others in necessary situations. He stated that the job of the supervisor is not predicting financial shocks—because “if anybody were really good at predicting financial shocks they ought to step forward and tell us about it”—but rather one of real world interactions and analysis of institutions and people with which it is intimately familiar.

Neiman stated that it is important to create a supervisor to close the regulatory gaps that currently exist and to include a diverse range of institutions under the umbrella of systemic risk supervision because it is unclear *ex ante* which institutions can cause systemic problems in the future. He added that the financial sector needs “think broadly about the types of entities, transactions, or practices that can create such systemic risk.”

Hawke agreed with Stern that “the role of the systemic risk regulators should not be entirely information gathering” but added that the lack of an overarching gatherer of information contributed heavily to the present crisis, making it important for the supervisor to have that role. Hawke stated that the additional powers of the regulator are not readily apparent because it would have to work with the current regulators who have “very disparate sets of powers”—as for example with the Federal Reserve having broad involvement with and power over banks and the SEC having oversight authority of the securitization industry in quite a different manner—and coordinate its activities accordingly to enable cooperation among it and the other supervisory institutions.

Whiting stated that the primary prudential regulator should not have the role of oversight; rather, there should be several oversight institutions at different levels that report to the main regulator when they detect problems. He stated mainly that the primary prudential regulator needs authority to intervene. He analogized the oversight role to that of the FDIC, which reports problems to the primary prudential supervisors on the issue and asks for intervention.

## **VI. *Keynote Speaker: Paul A. Volcker***

James C. Orr, Executive Director of the Bretton Woods Committee, introduced the symposium's keynote speaker, Paul A. Volcker, Chairman of the White House Economic Recovery Advisory Board and Former Chairman of the Board of Governors of the Federal Reserve System.

Volcker addressed the key economic challenges the U.S. faces today and focused on what he believes are the central issues of systemic risk and the protection of the effective functioning of the core banking system. Volcker began by stating the bad news: The U.S. and the rest of the world are in the middle of a recession and that "marked by a breakdown of financial systems, national and international, markets remain uncertain, unsteady and dysfunctional despite trillions of dollars that officials have brought to banks and other financial institutions." The good news, Volcker said, however, is that "past illusions are shattered." These illusions include the blind "faith in the extremely aggressive compensation practices as a means of encouraging constructive risk taking" and the overselling of and overreliance on the ability of complex financial engineering to manage and dispose of risk. "Now we understand that neither the incentives nor the defenses, however financially rewarding they were for those participating, were consistent with reasonable and necessary financial stability," he added.

Volcker urged that there needs to be a "coherent approach towards the markets, institutions, and the official responsibilities" when structuring reform. He stated that politicians often have "the desire to strike when the iron is hot" and typically follow the mantra that "no big crisis should go unrewarded by reform," which Volcker agrees is true in this case. He noted that Barney Frank, Congressional Representative for the Fourth District of Massachusetts and Chairman of the House Financial Services Committee, for example, is avoiding piecemeal reform and waiting to draft a comprehensive reform approach.

He stated that any successful reform will be successful "in a pretty intricate manner" and that the moving pieces of the system must work by themselves and in coordination with others "because it is not just a matter of deciding upon particular pieces of the reform puzzle, and each of those have their own complexity." To exemplify the problem Volcker noted that he heard about six different reform proposals for CRAs but found none of them convincing. "In any event, success in reform depends upon all those individual pieces,

how they all fit together,” Volcker stated, “and hopefully reinforce each other and not conflict with each other.” He stated that there are also additional areas of reform that will require international cooperation, noting that capital requirements and accounting as examples of areas with good international coordination at the present time.

Volcker pointed out that there are issues which regulators need to address in the area of “business practices, including the needs of transparency, fair dealing, and consumer and industrial protection” because there have been “quite clear failures” there. Volcker briefly endorsed the proposal<sup>13</sup> of Henry M. Paulson, Jr., former Secretary of the Treasury, of creating a single agency to deal with business practices in various industries. He declined to address further this topic, however, because “the heart of this kind of regulation” is quite different from prudential regulation, which Volcker continued to discuss.

Volcker stated that central banks have characteristics— independence, financial resources, professional competence, and continuity—that “all point towards [the idea that] these institutions have a critical role in fostering and defending financial stability,” meaning controlling the money supply or the federal funds rate. He added that although the primary responsibility of the Federal Reserve is monetary policy, “the responsibilities go beyond that towards a more amorphous concept of financial stability which, of course, right now has been lost.” He stated that although the Federal Reserve Act fails to clearly assign to the Federal Reserve a broader role of maintaining financial stability, everybody often assumes that it has an implied responsibility to function in that capacity. Volcker stated that a common theme among many reform proposals, including the G30 proposal,<sup>14</sup> is that a central bank must not only “have access to and ability to collect and analyze all information relevant for judging potential structure stability” but also have some authority, including the “authority to impose measures of various sorts that would temper emerging financial excesses.” He explained further that the central regulator must have authority to regulate “the core function of markets and core sources of concern,” including “leverage

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<sup>13</sup> See THE UNITED STATES DEPARTMENT OF THE TREASURY, THE DEPARTMENT OF THE TREASURY BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008), available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

<sup>14</sup> GROUP OF THIRTY, *supra* note 7.

restrictions, capital standards, collateral practices, clearing and seminal arrangements.”

Volcker next commented on the idea that the central bank role should be one of oversight, and specifically extending and confining the oversight role of the Federal Reserve to “direct regulation and supervision of particular financial institutions that are deemed systemically significant.” He stated that it is easy to justify official intervention and supervision of such systemically significant institutions because their failure would adversely affect the remainder of the financial system. He noted that there has already been a significant amount of government control over large and systemically significant non-bank institutions, which “has been an important, indeed an historic, development in regulatory and supervisory practice and . . . in central banking practice.” Volcker then discussed the implications of such regulation. He stated there should be “especially diligent supervision” of these institutions to deal with the problem of moral hazard. More importantly, he stated, such regulation will require the regulators “determine implicitly which institutions are inside the significant ring and which are not,” which “itself brings up implications for competitive equality and fairness.” He expressed strong doubt that regulators should explicitly determine “the circle of significance”—“which institutions are in and which by implication are out”—and stated additionally that “we should not encourage as a matter of general policy the view that some financial institutions ought to be assured of official support,” which is the current presumption. Volcker added that this, to him, is an argument against giving the Federal Reserve a detailed supervisory role over large systemically significant institutions. Volcker believes that a degree of ambiguity is necessary to address the moral hazard concerns of regulating systemically significant institutions. Volcker stated that “in practice, a distinction can and should be made in the intensity of supervision directed towards those banking institutions deemed so large and so interconnected as to pose systemic risk,” but that there should not be a rigid or publically announced dividing line between systemically significant and non-systemically significant institutions.

Volcker then stated that the U.S. has long drawn the line between “commercial banking organizations and other depository institutions [and] the case for maintaining that approach strikes me today as both practical and meaningful.” He stated that this could be achieved through “assigning regulation and supervision of all depository institutions to a single prudential regulator which is not

necessarily the Federal Reserve.” He noted that banks are in charge of operating the domestic and international payments systems and function as “main depositories and transfer agents for financial assets.” It is important, therefore, Volcker stated, that banking organizations “remain strong and stable providers of financial services—domestic and international, for households, businesses large and small, and governments—and that implies a certain fiduciary responsibility in my mind.” In this regard, he continued, “the priority is or should be to respond to the needs of customers for safe and liquid assets, for credit, whether in the form of loans or securities, and in many cases for financial advice and counsel,” and “underwriting as well as advisory work for companies fits into the broad concept I am urging.” On the other hand, Volcker stated that a market category that is not central to the banking mission “is extensive participation in impersonal transaction-oriented capital markets.” He said that this category “almost inevitably entails substantial risk, . . . adds a layer of complexity challenging for management, [and that] insidious conflicts of interest inevitably arise with their customer relationships.”

In light of the aforementioned distinction, Volcker found that, to him, “the logic . . . calls for prohibition of banking organizations sponsoring hedge funds or equity funds, and strict supervision with appropriate capital and collateral requirements for proprietary securities and derivatives trading.” Volcker stated that the fate of AIG—a company which he described as basically an insurance company and “kind of a fake bank with a little affiliate attached to it”—“amply reflects the implicit financial and management difficulties of combining a core customer business with risk-prone capital market activity.” He stated that the point is not to make commercial banking risk-free, which has not been the case and will not be in the future, but rather to return to and focus on the core banking functions, a goal from which the system has unfortunately strayed by participating in capital markets in recent times. Volcker added, however, that significant legislative reform would need to occur for a system such as this to materialize (reform that would not amount to the resurrection of the Glass-Steagall Act), and that part of the Gramm-Leach-Bliley Act would require rewriting.

Volcker stated that additional oversight and “regulation of non-bank financial institutions is inevitable and appropriate to some extent.” He stated that requiring registration of hedge funds and equity funds is “a minimal step,” that “reporting to authorities their business models and particularly large positions is widely considered

appropriate,” and that “collateral requirements and/or a need for lending restrictions with official oversight for the largest, and therefore systemically significant, individual institutions should be reviewed.” He warned, however, to resist the temptation to extend the “too big to fail” presumption to non-bank institutions and provide federal funds to those institutions.

Volcker concluded: “There is a plain need for major reform with particular pieces falling into a logical pattern with an agreed prudential framework.” The financial crisis is a “wakeup call” that “financial markets have indeed broken down.” He stated, “I never thought I would live to see the day when the American financial markets were dependent on the degree of government support and intervention that we have today.” Volcker emphasized once again that reduction of systemic risk and protecting integrity of core banking functions should take priority at this time. Eventually with the passing of time, however, the financial system needs to reach a point where it has some flexibility and space for renewal and experimentation in the capital markets, Volcker stated. In other words, the current government-provided “life support” for the financial system is necessary to recover it from its past excesses, but this support in time should give way to freedom and flexibility.