

SEC Historical Society

International Financial Regulation March 10, 2009

THERESA A. GABALDON: Good afternoon and welcome to today's program on International Financial Regulation, presented by the Securities and Exchange Commission Historical Society and broadcast on www.sechistorical.org. I am Theresa Gabaldon, Lyle T. Alverson Professor of Law at The George Washington University School of Law and moderator for the program. The SEC Historical Society preserves and shares the history of securities regulation through its virtual museum and archive at www.sechistorical.org. The museum is free and accessible worldwide at all times. The virtual museum and archive as well as the Society are separate from and independent of the U.S. Securities and Exchange Commission and receive no government funding. We thank the many institutions and individuals whose gifts and grants make possible the growth and outreach of the virtual museum and archive, now hosting over 8,000 visitors each month.

Today's program is a special broadcast on International Financial Regulation. We had originally planned to offer an online program on international regulation live from London later this month. The current financial situation necessitated a change of focus and location for today's program. I would like to express the society's gratitude to Mark Berman, a retiring Society Trustee who inspired the idea for a program on international regulation and who will be holding a conference on SEC regulation outside the United States in London later this week. I am delighted today to welcome two of my colleagues from GW Law School, Lawrence A. Cunningham, the Henry St. George Tucker III Research Professor of Law and Arthur E. Wilmarth, Jr., Professor of Law. Their remarks today are solely their own and are not representative of the opinions of the Society. They cannot give legal or investment advice.

Before we begin however, I would like to quote from a Newsweek article written by Fareed Zakaria on February 2nd. He states, "This current crisis has resulted in a deep erosion of American power that we have not fully understood. Even in the depths of the Iraq War where much of the globe was enraged by George W. Bush's unilateralism, people everywhere believed that the United States had the world's most advanced economy and that its capital markets in particular were the most sophisticated and developed. American officials, businessmen and economists lectured far and wide on the need to copy the American system. That system is now seen across the world as a sham, a casino game in which highly paid participants mismanaged risk and highly respected regulators cheered them on. I have traveled to Europe, Asia and the Middle East in the past three months and I am writing this from Canada. The attitudes of officials and businessmen range from shock to rage at what they see in the United States."

Art and Larry, on that cheerful note, welcome.

THERESA A. GABALDON: I am hoping that one or both of you gentlemen might start us off by describing the state of international financial regulation as it existed say 10 years ago.

ARTHUR WILMARTH: I think it's certainly been very much a system in progress. International financial regulation in the contemporary sense probably began with the Basel Capital Regulation Accord that was adopted in 1988 in response to the very serious lending problems that major banks across the world got into by lending to developing countries during the 1970s, and then a series of sovereign defaults occurred in the early 1980s. And it became very clear that these large banks were holding very little capital against the risks on their balance sheets and regulators from

different countries had widely varying notions about how much capital banks should hold. So, in the modern era, Basel represents a watershed because it was a collective agreement instead of a series of government to government agreements. The Basel accord was, as some people said, soft law in the sense that government regulators agreed to adopt these common capital standards, but the accord was not embodied in a binding treaty. The banking industry was involved and the banking industry essentially agreed to comply with the Basel standards. And that began a public-private dynamic or interface in international banking regulation. I think we have seen that dynamic continue over the last 20 year, both for good and for ill.

LAWRENCE A. CUNNINGHAM: That sounds right to me. In the past decade, we have seen increasing globalization, and as a result, increased capital flowing across borders. I think 10 years ago the regulatory apparatus didn't necessarily anticipate the significance of these flows or how cross thatched the financial relationships would be. Ten years ago you had the Basel effort and some coordination among securities regulators and accounting standard setters, but I think it was all quite inchoate, informal and a little bit behind the curve. Now there has been a sort of recognition that the international financial regulatory system is probably not as up to date or modern as it needs to be, given this flow of capital across borders and the significance of organizations, business enterprises and financial institutions that really transcend traditional national boundaries.

ARTHUR WILMARTH: Your opening quote from the writer from Newsweek is interesting because in the 1990s regulators decided that the original Basel Capital Accord wasn't working very well. Basel wasn't adequately capturing or expressing the risks that banks were increasingly absorbing in off balance sheet vehicles and by using exotic and complex instruments. Regulators decided that a new Basel accord was needed. The new Basel II accord was hammered out eventually in 2004. There's an old saying that when you point a finger, three fingers are pointing back at you. The Europeans played a very big role in Basel II and pushed it very hard, while many of the Americans – especially the FDIC - were quite skeptical about Basel II. One could certainly make the observation that Basel II if anything gave the large financial conglomerates even greater authority and greater discretion to establish their own capital rules and to pursue their various business strategies. In a sense, Basel II pushed government regulators back into a more passive role. European banks and the U.K. banks are just as implicated, just as involved and just as damaged by this current crisis as the U.S. banks have been. Although the particular crisis of which we are speaking may well have started in the U.S. subprime housing market and it is continuing to unravel, we see many of the same problems, for example, in the property markets in U.K., Ireland, Spain, Eastern European economies. What you see is an enormous explosion of credit under very reckless circumstances that was fed by the large financial conglomerates and spread around the world. As Larry and I were discussing earlier today, you also have some very interesting overlays between what these large institutions were doing and what the monetary authorities were doing. There was an interaction between how the banks created the credit boom and what the currency exchange ratios looked like between the U.S. dollar versus the Chinese yuan versus the Japanese yen versus the euro, versus the pound. I certainly agree that the U.S. bears a huge amount of responsibility but we don't bear all the blame for this disaster. I think the fact that it's a global disaster indicates that there many, many players in this particular tragedy, you might say.

LAWRENCE A. CUNNINGHAM: That sounds right to me too. And the Newsweek commentator is providing some insight. He's really got his finger on the pulse of attitudes in other countries, even if they aren't entirely right in that this crisis incubated in different sectors all across the world. There are a lot of grounds to point fingers here or there or elsewhere. But it probably remains the case that if the United States enjoyed a reputation as being a leader in effective capitalism with fancy regulators and systemic controls and that's clearly broken down. Even if fault can be

shared widely, the perception of the United States's role in this crisis is probably still very significant.

ARTHUR WILMARTH: We in the United States should have known that our financial institutions and markets would be held to a higher standard. From my perspective, it is very disturbing that these giant financial institutions seem to have been able to influence regulators in the U.S., Europe and the U.K., no matter what regulatory system or structure was in place. One of the questions that Theresa indicated she might want us to talk about was, is whether one regulatory structure is better than another. Part of my response is, well, the outcome seems to have been the same in terms of a lack of effective regulation.

THERESA A. GABALDON: It's interesting that when we start to talk about international financial regulation, what we seem to be focusing on first is perhaps the U.S. as one type, another country as another type. Maybe we can back up a little bit and actually see if we can describe what is international financial regulation? What does that really mean?

ARTHUR WILMARTH: As we have seen so far, there really is no single, global interconnected, coordinated system of regulation. The Basel Committee is a group of the major central bankers and financial regulators who come together and reach agreements on different protocols and standards and guidelines by consensus. You can also look at the International Monetary Fund and the World Bank but they have relatively confined roles in a more emergency sense and they really don't have many direct impacts on what the major financial institutions are doing in the developed countries. Some people argue that maybe we ought to give the IMF some kind of a more direct oversight authority. But I think that's quite a long shot, because it would be very different from what we have now. At present, we have a series of conversations and cooperative efforts between regulators, particularly in the other OECD countries. They often reach agreement, but it's all done in a sense by consultation and consensus. There really is no well established framework for requiring regulators to act in a certain way and I think part of the difficulty in responding to the current crisis has resulted from the fact that the various central banks and regulators in different countries have not responded in the same way. There has been a relatively high degree of cooperation but there has also been inconsistency as well. There have been some discussions about whether we need some sort of international super-regulator. That might be something we might see ten to 20 years down the road, depending on whether we are able to resolve the present crisis. Our difficulties in organizing an international response to the current crisis might lead to some serious thought about whether a more formal type of coordination needs to be established.

LAWRENCE A. CUNNINGHAM: Right. In the spirit of stepping back a little, we need to think about what exactly we are regulating when we are talking about financial regulation. Obviously we are talking about markets and institutions that deal with financial matters or financial capital. One can delineate that to include banking institutions, insurance companies, mutual funds, broker-dealers, maybe even securities markets, futures markets, private pools of capital like hedge funds and you could break it down even further. And, as Art is saying, there certainly is not a formal international regulatory apparatus that governs all of these markets. In fact, there is not even anything fully formed at an international level that formally regulates any of those particular components of the overall financial system. The global dimensions of this crisis do suggest at least some need to consider the possibility of more formal coordination. Basel's a nice inchoate beginning to that regulation, but as Art was explaining, it was a private-public partnership that included senior central bankers from the G-20 or so countries and the banking industry. I think they succeeded considerably in trying to develop a definition of capital in a sense of capital adequacy, which is quite a feat considering that those notions are contextual and

cultural. But we are probably at least 15 to 20 years away from developing a coordinated international financial regulatory system, and yet currently there is considerable interest and discussion in trying to try to think about how something might look. I think a critical piece of international financial regulation is probably at the central banking organization in any given country, such as the board of governors of the Federal Reserve in the United States, the Bank of England in the United Kingdom, the European Central Bank in Europe, and their equivalents in 20 or so other leading countries. They could begin a process of talking about how to identify financial risks that have potential international implications and coordinate information sharing about developing concentrations of financial risk. As a result, they could attempt at least some dialogue and some information sharing to get out in front of those developing risks. And then one would have to think about similar elaborations across not just banks but insurance companies, futures, broker-dealers and so on. As we have seen, the task of defining international financial regulation is, in itself, difficult. But just figuring out even the logistics of who would participate and how they would coordinate, I think is a Herculean task.

ARTHUR WILMARTH: I think the AIG crisis is a good example. It was the world's largest insurance company and had established a quasi investment bank, a quasi hedge fund operating within its umbrella that basically wasn't regulated by anybody. The insurance regulators weren't watching it. The Office of Thrift Supervision had nominal authority but never really looked at it. The Fed had no authority over it. And so this AIG unit wrote over \$450 billion worth of so-called credit default swaps, which essentially were insurance policies, and AIG sold those policies to financial institutions all over the world - particularly in Europe - to reduce their capital requirements. AIG presented its "AAA" rating as proof that they would be able to pay if the underlying credit exposures defaulted and then of course we find that AIG couldn't pay. Instead, the Fed has had to provide \$170 billion of assistance to AIG because, if it did not, the Europeans banks and some American banks would be suffering many billions of dollars of losses and might be forced into default. So, clearly, AIG is a prime example of how, until the problem broke into the open, these interconnections between major financial institutions were not understood by the regulators and the markets. Paul Volcker, the former Fed Chairman, has been talking about the need for greater transparency and greater oversight of what he calls systemically, significant financial institutions, no matter what kind of charter they hold or where they are located. And this is where the central banks need to focus their most immediate attention - namely, how do we identify those institutions that are either too big or too interconnected to fail without dragging down other major institutions and how do we get some kind of meaningful control over the kind of risks they are taking?

LAWRENCE A. CUNNINGHAM: Right. I just want to amplify the point that AIG was an insurance company, but it also had certain features of an investment bank, and maybe even some features of a commercial bank. This reflects how, within the United States, the regulatory system tends to be fragmented so that we have assigned an ad hoc regulatory response according to the different kinds of businesses in which enterprises operate. States tend to regulate insurance, banking is regulated at both federal and state levels depending on whether a bank is chartered at a federal or state level, and investment banks are regulated at a federal level by the Securities and Exchange Commission. That kind of fragmented model certainly has some advantages in allowing different regulators to experiment with different approaches and maybe it enables one regulator to exert some pressure when another is unable to see something. But there are some clear disadvantages to this model because there is no single supervisor that can command all of the information about all of the different financial institutions that participate in these markets, and this can make concentrations of systemic risk invisible to individual regulatory agencies. Then the problem amplifies when you move to the world stage where there is a functional fragmentation; United States regulatory authorities may have some capacity to

oversee a company like AIG generally, but not all of its operations because many of them were run in London. The Financial Services Authority, the principal financial regulator in the United Kingdom, may have been able to learn something about some of AIG's activities but maybe not about everything. And so there is international fragmentation in which no single regulatory authority has complete information.

I think Paul Volcker's idea is not only to try to rationalize regulatory oversight within given countries, enabling the United States to appoint one senior regulatory authority to oversee a complicated organization like AIG - something like a Central Bank of the United States or the Federal Reserve. But then likewise to enable central bankers in the other 12 or 20 leading countries to do the same thing and to coordinate these 12 or 20 central bankers into something he calls a college of supervisors. That body would then perform the functions to which you are referring, by trying to understand on a global basis where risks are concentrated. These central bankers, at a minimum, would be able to share information about systemic risks. What happens next is that regulators have authority to instruct firms not to do certain things, to limit the size of their trading activities, or to maintain a minimum amount of capital. I think that's the quest I see in Paul Volcker's vision: not only to concentrate regulatory authority within a senior supervisor in each country, but then to have the horizontal coordination among 12 or 20 leading central banks.

ARTHUR WILMARTH: The AIG story demonstrates that there have always been powerful financial industries in this country that have tried to make sure that the Fed could not supervise them. One was the insurance industry, another was a thrift industry, a third was the investment banking and securities industry. So even though AIG or Goldman Sachs or Morgan Stanley or Merrill Lynch or Bear Stearns or Lehman Brothers were systemically important financial institutions, until the crisis broke out, they all operated under loophole statutes and made sure that the Fed couldn't see what they were doing. And it is ironic to me that the sub-text of the Paulson Financial Modernization Plan was essentially to reduce further the Fed's ability to oversee the risks of major banking organizations and to take supervisory action to those risks. Supporters of the Paulson plan said, well, look what the British have done - they have basically taken the Bank of England out of the bank supervision business completely and left it only as a monetary authority and paradoxically as the lender of last resort, which makes no sense if the Bank of England has no supervisory authority to go along with its lender of last resort responsibility. And the British give all the supervisory authority to the Financial Supervisory Authority, the FSA and we see how well that worked out when the Northern Rock crisis hit because the FSA apparently didn't tell the Bank of England how bad things were until Northern Rock was very close to failure. And then the Bank of England responded, why should we help out, it's not our problem. And we don't think we should help out in any case for moral hazard reasons and then the whole thing fell apart and you had your first bank run in England since 1866. So interestingly, there's been this long debate over the last 15-20 years about getting the central banks out of the business of bank supervision or financial supervision generally. But if they are the only ones who can provide this systemic risk support through the lender of last resort function. I think this current crisis has shown us that the central banks are not going to be able to control systemic risk effectively without direct supervisory authority. As the Northern Rock, Bear Stearns and AIG episodes who, you will have just one emergency bailout after another unless they can exercise some real supervision before the crisis hits.

LAWRENCE A. CUNNINGHAM: I think that's right too. The U.K. model is interesting because it really does concentrate regulatory supervisory authority in a single institution, the Financial Services Authority. It cuts the Bank of England substantially out of that role, remitting it to a monetary policy function and lender of last resort function. I think what's interesting about the main proposals on the public agenda in the United States, one by Paul Volcker to which we referred to a couple of

minutes ago and one by Henry Paulson, the former Treasury Secretary to which Art just referred, is that both of them imagine something more like what people call a twin peaks model. Under this model, we would have two super senior regulators. One of them would be responsible for systemic stability. The Federal Reserve or some other central bank would be interested in supervising banking institutions, assuring that they are solvent and thrive and prosper and don't need to be bailed out of situations like this, so that the central bank wouldn't have to provide that lender of last resort function. There would also be a separate regulatory authority whose mission is to protect depositors and investors and other consumers. It's really important to have those two separate functions because interests conflict. If I'm the Federal Reserve, I want my banks to survive and prosper and that might mean I don't want them paying into a reserve fund or paying restitution or damages. But if I am the ambassador for the depositors I want the reserve fund and I want the restitution. So I think what's nice about the Volcker and Paulson proposals, which are otherwise sort of competitors, is that they both appreciate that a single supervisor model, like that which was dominant in the United Kingdom, has at least one big problem. At the minimum, the way forward in the United States is to separate those two functions. Also, I think the U.K. may be learning a lesson. I think the Bank of England and FSA have functionally renegotiated their powers in the light of Northern Rock and the more recent problems that the other banks, like the Royal Bank of Scotland, have had. The Bank of England is not likely to be content simply providing a lender of last resort function and it will likely be more proactively interested in assuring protection of depositor. So there maybe some slight emerging consensus that a two peaks model with some regulatory tension in it might be important or desirable.

THERESA A. GABALDON: This is fascinating because what we seem to be hearing here is that international financial regulation, well, not so much but at least we can learn from each other's mistakes.

ARTHUR WILMARTH: That it is a work in progress. to say the least.

THERESA A. GABALDON: Somehow work towards some sort of system of coordination and communication. And I am curious if there is any answer to the question. Suppose someone, some government official in the United States finds out about a building systemic problem here, who does he call in the U.K. or she calls in the U.K. or is no call made?

ARTHUR WILMARTH: That's a good question. I think it does call to mind about the situation where AIG had big operations in the U.K., including its credit default swap unit, like many other large institutions. Lehman Brothers had very big operations in the U.K. and that's been very much a point of contention in the ongoing bankruptcy proceedings. I always assumed that if the Fed thought there was a problem in the United States involving Royal Bank of Scotland or there might be a problem in London involving Citigroup, then either the Chairman of the Fed or some authorized subordinate would pick up the phone and call someone, most likely in the FSA, although perhaps in the Bank of England and they would have direct conversations about the problem. I am not sure that that kind of informal consultation always occurs but I do get the sense that since the crisis has broken out there has been reasonably good supervisory coordination, particularly among the central banks. Sometimes among politicians it's been more difficult to decide, for example, what level of fiscal stimulus each country should pursue, and there have been disagreements about that. But with regard to the lender of last resort and emergency liquidity operations of central banks, there's been quite a high degree of coordination - probably more than we have ever seen before. I think that unusual amount of central bank coordination unfortunately indicates how serious the present crisis is, because it has forced all the central banks to realize that they had to work together and work together very aggressively.

LAWRENCE A. CUNNINGHAM: That all sounds right to me. I am just going to build on that last point. We have witnessed a considerable amount of regulatory reform in the past eight months that has been unplanned, ad hoc, and on the fly, both within the United States and within at least a dozen countries. The main import of that reform is concentration of regulatory authority across the variety of different financial institutions and types of institutions into a super senior regulator in the United States. This is mainly the central bank and the Department of the Treasury, headed by Ben Bernanke and Hank Paulson, until recently, and now Tim Geithner. There has been an equivalent concentration of authority within the United Kingdom in a couple of super senior members of the Bank of England and the FSA, and you see that in a number of other countries. And then simultaneously, the horizontal coordination has begun. I mean what Paul Volcker is imagining is already, in a certain way, happening. So I suspect that Ben Bernanke has certain avenues of communication to his counter parts in a dozen or 20 other countries. And of course so does President Obama and Prime Minister Gordon Brown who obviously spoke the other day and I think this was a very important part of what they were talking about. I suspect we will have a continuation of this, so that the informal channels that have developed are going to be in place and stay in place.

ARTHUR WILMARTH: Larry is right that regulatory reform is happening on the ground as an indirect result of these emergency ad hoc rescues. For example, the second Basel accord is being totally rethought. The Swiss Banking Commission recently said that they would reinstitute a leverage capital requirement, based on Tier I equity divided by balance sheet assets because the Swiss discovered that their two biggest banks, UBS and Credit Suisse, use Basel II and internal risk-based models to slash their effective equity capital to under 2%. In this country, an institution with a leverage capital ratio below 2% is considered to be critically capitalized. Unfortunately, we have discovered that some of the biggest U.S. banks used similar techniques to reduce their tangible equity ratios to levels that are certainly hazardous. The FDIC was the one regulator in this country that kept saying, no, we need a leverage ratio, and it needs to be kept high. I think it is no coincidence that the FDIC had the strongest stake in protecting the integrity of the deposit insurance fund. The other thing is this whole idea about transparency. Larry made a good point about how our financial markets have this brand – or at least this reputation - of being known as the most transparent markets. Well, that really wasn't true because we had allowed \$2 trillion of assets to migrate into hedge funds that were completely opaque, and their whole rationale was to be hidden from any market oversight or supervision. To the SEC's credit, they tried to do something about hedge funds. However, the SEC got slapped down by the courts when they tried to force hedge funds to register as investment advisers. Under Chairman Greenspan, the Fed did not show any interest in forcing hedge funds to be more transparent. At the same time, you had this tremendous growth of these over-the-counter, customized, opaque derivatives, including credit derivatives, which were not traded on any exchange. With AIG and others we now find the kind of tremendous exposures that can result from unregulated derivatives. So one interesting proposal is to force more of this unregulated economic activity onto organized exchanges. If derivatives are traded on organized exchanges, then market participants as well as regulators can figure out which firm is holding what position, what kind of collateral they are holding against that position, and whether it's an excessive or speculative position. We didn't have any of that type of information on hedge funds and OTC derivatives until the financial markets began to break down in the middle of 2007. So I am afraid that whatever reputation the United States had for transparency has been essentially lost over the last 15 years or so.

LAWRENCE A. CUNNINGHAM: I agree with that might be something to which Fareed Zakaria is referring to when he writes that Newsweek article that Theresa quoted at the outset. That was the reputation, or the legend as Art puts it, and it turns out not to be true. And there was a regulatory conspiracy involved in it too because as

Chairman Greenspan understood this and let it go. Another thing that I see in common between Paulson's proposal, Volcker's proposal and much of the talk around the world by the finance ministers of the G20 who released a sort of communiqué and a joint expression of commitment to recapitalizing banks and promoting systemic stability and protecting consumers, is precisely a focus on transparency. Throughout all of these markets and sub-markets, there is a focus on making all of them as transparent as the traditional securities markets in the United States have been. This includes these credit default swaps and derivative contracts. I also detect at least a modest consensus among regulators and participants alike in the need to create some form of a public exchange for these sorts of derivatives contracts, probably a proprietary organization based in Chicago and overseen by something like the CFTC or the SEC. I see a reasonable amount of support for that. I doubt everyone will agree on all the details but I think transparency is a clarion cry that does seem to command a considerable assent within the U.S. and abroad.

ARTHUR WILMARTH: Larry has written extensively on accounting issues and the question of whether we are moving towards a global accounting accord. Certainly accounting and disclosure are part of the broader issue of transparency and market discipline. An important question is, do you think we can get to a single set of international accounting standards that might actually provide at least reasonable transparency?

LAWRENCE A. CUNNINGHAM: There continues to be a considerable enthusiasm among a wide variety of people in the aspiration of having a single, high quality set of international financial reporting standards. A tremendous amount of work and progress has been made in the last 15 years. There is an existing set of such things that's pretty good. I don't think anyone thinks it's perfect but it's got a lot to recommend itself. There was an extraordinary amount of excitement about it until a year and a half ago. I think now, this episode, the crisis itself and some of the responses to it have slowed down that momentum a bit. Principally this slow down was because of the problem of how to value some of these instruments that are very complicated, whose value depends on a lot of different variables. In a properly functioning market one might be able reasonably and confidentially to describe and assign a value to them and provide some transparent accounting reporting. But in a distressed market, in an impaired market when no rational counter party would buy these things, maybe the value is zero. The accounting standards envisioned measuring these things at whatever the market trading value would be, but in a distressed market that would be zero. So there is a considerable controversy about whether this idea of transparency and current value of these things was a culprit in this crisis, that if for the banks or any holder of assets that are under distress, because the markets are under distress have to write these things down...

ARTHUR WILMARTH: It's a downward spiral.

LAWRENCE A. CUNNINGHAM: You get a downward spiral. We always joke that every scandal requires an accounting culprit. This one's fair value accounting. But this is a highly contested issue because there is also a case that if it's worth zero, well, we ought to know that's worth zero and that's the idea of transparency. But it points up to your question, that there is some need to continue the dialogue about international financial reporting standards. How did the standard setters respond during this crisis to the pressures that naturally grew up? Were they captured by the banks that they were supposed to have just been umpiring? And so I think it has reduced some of the enthusiasm but there is still serious conversation and work being done and it's not a bad forum to continue the question that we began with here about how international financial regulation is constructed.

ARTHUR WILMARTH: One way to think about fair value accounting is that it's pretty hard to have fair value accounting if you don't have organized exchanges and

if you have opaque assets. I remember that, before that the crisis got really bad, I read in an article that reported that the top five securities firms had designated much of their so-called fair market value assets as Level 3 assets that were marked to model assets. Fair market value accounting makes a lot of sense to me but it doesn't seem to work very well if you don't have organized markets and transparent assets. Basing fair value accounting on Level 3 mark-to-model assets seems like pouring oil on water.

LAWRENCE A. CUNNINGHAM: Yes, the mark to model becomes a mark to myth. You are sort of making it up. You are imagining you are constructing a hypothetical market that would exist if people wanted this stuff. This is a serious problem. One of the quips I remember best in this whole crisis occurred in October of 2007 when Ben Bernanke was giving a speech at the Economic Club of New York. One of the questions from the audience was, "As a central banker what information that you would like to have that you currently don't have?" And his answer was, "How do you value these damn things?"

ARTHUR WILMARTH: That's true and when you understand the points we were discussing earlier today, you say to yourself how much of the crisis really resembles the Enron scandal on a massive scale? Because Enron had all these complex derivatives, these complex off-balance-sheet debts and these opaque assets that were valued by mark to model accounting. Enron's accounting inflated their earnings on the upside of the business cycle and then crushed them on the downside. We don't seem to have learned very much from the Enron episode, because the subprime crisis has many elements that look like Enron on a huge, industry-wide scale.

THERESA A. GABALDON: And speaking of the transparency issue certainly for years we have been hearing about the wonderful transparent American markets. We have also been hearing something about regulatory competition and there is a price paid for our transparency in terms of increased cost of raising capital and figure that somehow we are going to lose some sorts of business to overseas regulators who might be more lax. Now I don't hear either of you talking about regulatory competition. Is that something that we just aren't going to hear anything about for another few years?

ARTHUR WILMARTH: I think one hears more about regulatory competition in good times. It is ironic that the light touch regulator that was held up as the model for all regulators was the Financial Supervisory Authority in England. They openly advertised themselves as the light touch regulators and the market friendly regulators. Treasury Secretary Paulson and others expressed concerns about all the securities listings and IPOs that were going to the U.K. I haven't done any research on this point, but it amused me when I read articles indicating that a lot of the London listings were from Internet gambling companies or Russian companies. These companies struck me as not very good candidates for American markets anyway. I have seen some formal studies concluding that New York was not going to lose its status as a leading global financial center. The FSA has recently announced that they are light touch no more. If anything, there's been more of a re-regulatory reaction in the U.K., partly because their financial sector was even larger as a percentage of their economy than ours is and so they have suffered proportionately even more than we have. Light touch no longer appears to be part of the regulatory vocabulary in London. Nevertheless, until the crisis broke out, regulatory competition was alive and well and operating in a very aggressive way over the last 15-20 years. Large financial institutions were able to get regulators to do what they wanted. I could give you a number of examples that would bore you. Certainly, the Office of the Comptroller of the Currency, the regulator of national banks, advertised itself as the light touch of U.S. banks. The OCC has long wanted to be the exclusive Federal bank regulator, and they have long pushed for the creation of a Treasury-centric bank regulatory role that would get the Fed out of any supervisory oversight. As you may have noticed, the

success rate of the OCC in preventing serious bank problems among their major banks is about the same as the FSA's record. Wachovia has essentially failed. Citigroup is a zombie bank, and Bank of America is gravely wounded. I hope that the proposals to create a FSA here are now defunct, but I suspect that we will hear about such proposals again when the economy improves.

LAWRENCE A. CUNNINGHAM: I think you will hear it again and I think President Obama certainly wants to put an end to it. Last Wednesday at the White House with his financial advisors flanking him he announced seven principles that need to guide financial regulation reform. They were seven very simple sentences and the sixth one was, "We can't have regulatory competition." So he would like to put an end to that competition talk and otherwise. But to come back to that description of the United States regulatory system that I summarized earlier, I call it a fragmentary system because insurance is at the state level, futures is at the federal level, securities is a bit of state and federal, banking is both federal and state. Additionally, there are divisions across the federal government, especially in banking. There are turf battles between the SEC and the CFTC, as well as within state corporation law, obviously there are 50 states from which to choose and there is evidence that some states at least like to compete with others. This is a model of regulatory competition and as I said before it has its virtues. It can enable experimentation and requires legislators and regulators to compete and to test their policies. Obviously there is a long standing debate about whether the result of something like that is a superior regulatory regime or a lax and captured one. But, when we talk about international financial regulation, even if we concentrated all of that within the United States into a single consolidated regulatory authority and said there should not be regulatory competition, we would still face challenges. So investment banks are going to be subject to some supervision whether they are under an SEC umbrella or a Fed umbrella or something else. There's going to be a uniform standardized regulatory framework. The challenge is going to be, will the U.K. do the same thing? And will Japan do the same thing? So all G20 countries and maybe more agree that we are not going to compete with each other for regulatory superiority or laxity but we are all going to have, to use Paul Volcker's phrase again, a sort of a college of supervisors, all of us on the same page. To take Obama's prescription seriously, that's what you would need. Not just limited regulatory competition in the United States but this extensive horizontal coordination and commitment around the world. Now there may be some difficulty or reason to be skeptical about the sustainability of that kind of model. Certainly, talk today tends to embrace coordination and concentration, collegiality and so on. Whether that will endure when...

ARTHUR WILMARTH: When the crisis goes away...

LAWRENCE CUNNINGHAM: When the crisis goes away you can start to see Czechoslovakia wanting to get a little bit larger share of the financial markets, or more realistically Dubai or Hong Kong. And so one does need to think, as we design the U.S. system and interface with the others, what competition will do. I think Paul Volcker's vision is that we can create a sustainable coordinated group of supervisors. In contrast, I think proponents of regulatory competition including Henry Paulson just don't believe that; they think the market won't permit it. So their thought is, we can concentrate regulatory authority within the United States but the purpose of that regulation is to compete with other countries, not to coordinate with them.

ARTHUR WILMARTH: Right. U.S. policymakers are concerned about regulatory competition because of the various offshore banking centers. It's not a surprise that the alleged Stanford fraud would have been operating out of Antigua or some place like that. There is a major question of how you can control all of these small offshore entities, the Channel Islands, Bermuda, Luxembourg and the Cayman Islands, when their economy depends upon financial activities conducted in their domain. Switzerland until recently promised total bank secrecy and now UBS has humiliated

Switzerland by their role in tax evasion. Switzerland is therefore obliged to give away some bank secrecy. That said, I agree with Larry that arbitrage operates in all markets except when they are not functioning. Right now they are not functioning but when they function again one would suspect that arbitrage of a regulatory sort would be back.

THERESA A. GABALDON: You have been talking about, oh well, we have been talking about the idea that sometimes we hear to chat about harmonization sometimes bad competition. If it's on a day or an extended 18 month or a longer period in which focuses on harmonization, do we have to worry about some very basic things as like whether our approaches can be harmonized? Are we in fact in more rural space regime than other countries which are generally said to be more principled, principle based? What's that all about and what do we need to do about it?

LAWRENCE A. CUNNINGHAM: I think this is a serious challenge for any vision of harmonization because our financial markets, our regulation and our laws are products of our civilization, and they all reflect cultural features of it. In this context, that includes a litigious culture. We like to litigate, besides baseball it is the favorite American pastime. That has a tendency to create demand for law in the form of clear rules rather than general principles, in order to enable people to create ex ante defenses: here is the rule book, we followed it to the letter and we should be insulated from liability. And so, you get a much denser form of law making in this country in probably all of our fields, but certainly in securities regulation, banking regulation and accounting regulation. In other countries, without that sort of tradition, there is less demand for that kind of clarity and specificity. Participants may be way more content with broad general principles about what is expected and what is permitted than we are here. A second reason for this difference, especially in the securities context, is that the United States is different from most of the countries in the world in the extent to which individuals have stakes in the securities markets. We always had a strong role of the individual investor and even today, with the proliferation of mutual funds and pension funds, still a larger percentage of Americans are exposed to the equity markets than in most other countries. That creates a peculiar cultural environment that manifests itself in rules and in other approaches to regulation that require harmonization. If we were to attempt to establish an internet of formal international financial regulatory system that bridged cultural chasms and these differences, that is a huge challenge. And we have seen it very clearly in the context of developing international financial reporting standards. You just confront it at nearly every consequential turn when trying to generate something that all the participants in the world can assent to.

THERESA A. GABALDON: Early on we heard little from you Art about public and private cooperation at Basel and one thing we haven't touched on today is what kind of role there might be for SROs or Self Regulatory Organizations in making things work on an international basis?

ARTHUR WILMARTH: Certainly the idea of an organized derivatives exchange would be an SRO and I think that a lot of people believe that if you are going to migrate from totally private and opaque to regulated and transparent, the idea of an SRO is useful, possibly as a way station, possibly as a stopping point, depending on how well the new exchanges work. I think that the Public Company Accounting Oversight Board that came out of Sarbanes-Oxley is another good example. The accounting industry was a totally private profession that was disgraced by what happened during the late '90s and the turn of the century. Congress could have decided, okay, let's make accounting entirely like a regulated utility. Instead, Congress set up a self regulatory organization, the PCAOB, with SEC oversight. Larry is in a much better position to judge than I am, but my sense is that PCAOB has been quite successful. And I think that there is virtue in not turning everything in the private market into a regulated utility. So I would be very comfortable in seeing

Congress take an SRO approach for derivatives trading and the regulation of hedge funds that market their investments primarily to what we would consider accredited investors. It is a promising way of moving forward from our present situation, where hedge funds hold large pools of investments, but are effectively black boxes to the regulators and the financial markets. I think SROs could be a useful way of bringing things out of the shadows and more into the daylight, without adopting a 100% top down government regulated approach.

LAWRENCE A. CUNNINGHAM: That sounds right to me and I concur in celebrating the Public Company Accounting Oversight Board, the self regulatory organization that Sarbanes-Oxley created. Certainly it has had its critics at occasional turns. It may have gotten carried away with one or two of the standards that it initially adopted; sometimes the auditing firms don't like how intense their inspections are or how deep into minutia the board gets when it inspects the firms. But I think on balance people appreciate that it's contributing a lot. And indeed one notes in the current crisis, auditing firms have not been held responsible for anything. I mean obviously they are deep pockets in a few lawsuits but they don't seem to be engines or drivers of the crisis and there is a chance that the Sarbanes-Oxley Act and the PCAOB has something to do with that. The other thing I would say about self regulatory organizations is that they come in such a wide variety of flavors and forms. The PCAOB is very interesting specimen created by Congress. The New York Stock Exchange is a different kind of one. FINRA, the sort of broker dealer enforcement apparatus at the Futures Industry Association is interesting. But they can be, I think, very useful because you get expertise and you get contact with the most important participants in the market. It may even be a way to make horizontal global coordination work so that super senior regulators can all get together in a single room and agree on a lot of stuff but then delegate to the SROs in their countries a lot of the day to day stuff.

THERESA A. GABALDON: Art and Larry, thank you for sharing your insights on international financial regulation. Today's program is now added to the growing number of materials on international securities regulation already in the museum's collections particularly "The Imperial SEC?" gallery written and curated by Dr. Felice Batlan of Chicago- Kent Law School; the April 22, 2008 Fireside Chat on the work of the SEC Office of International Affairs; the transcript of "Beyond Borders: A New Approach To the Regulation Of Global Securities Offerings," which was the subject of the Society's 2007 Annual Meeting; and interviews with Michael Mann, Robert Strahota and Ethiopis Tafara, current or former staff of the SEC Office of International Affairs. Today's program can be accessed again on demand in the Online Programs section of the Museum in MP3 and transcript format.

Next month, the Fireside Chats will return with the April 21st program on the SEC Office of the Chief Accountant with John Albert of the SEC staff and Gary Previts, Professor at Case Western Reserve University. The chat will be free and accessible worldwide without prior registration. Please plan to join us again on www.sechistorical.org on April 21st. Thank you for being with us today.