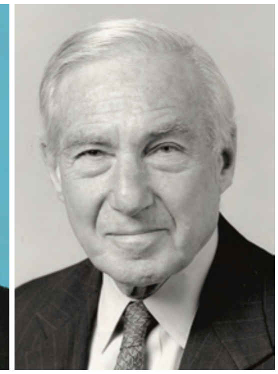
Executive COUNSEL
C-LEVEL INSIGHTS FOR BUSINESS LEADERS

Regulation and the Financial Crisis

An Executive Counsel Roundtable

It has been about nine months since the global economy started to implode, and events that had been unthinkable for most economists began to unfold with mind-numbing regularity. Today no one knows for certain whether we are at the beginning of a process or nearing the end of one. About the only thing most observers agree on is that the crisis began with a failure of markets in the United States and had something to do with regulation. Precisely what failed and how remains a matter of discussion and dispute, as do the closely related questions of how we dig ourselves out of the current mess and what needs to be done in order to prevent, or at least mitigate, the next crisis. Executive Counsel convened a roundtable to discuss these issue in late April.

Executive Counsel editorial advisory board member David Wingfield moderated the discussion. The roundtable was held at the New York office of Arnold & Porter. This is an edited transcript.



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✱ **Michael Mierzewski** is a partner at Arnold & Porter. Mr. Mierzewski specializes in financial institutions and corporate and securities law. Prior to joining Arnold & Porter, he was a law clerk with the Office of the Comptroller of the Currency. He is a former vice chair of the American Bar Association's Section of Antitrust Law Committee on Financial Markets and Institutions.

✱ **Alan Avery** is a partner at Arnold & Porter. He is a member of the firm's financial services practice. Mr. Avery concentrates his practice in federal and state regulation of banking organizations, and advises domestic and foreign banking institutions on the impact of banking laws on their global operations.

✱ **Kenneth Bialkin** is a partner at Skadden, Arps, Slate, Meagher & Flom, where he specializes in corporate, securities and financial matters. His practice includes international merger and acquisition, corporate finance transactions and SEC enforcement. He is a member of the Executive Counsel editorial advisory board.

David Wingfield, WeirFoulds: What role in this crisis has been played by mis-regulation, as opposed to the absence of regulation?

Mark Botti, Akin Gump Strauss Hauer & Feld: I think what you see from mis-regulation is that any error in the regulatory process can distort both incentives and investment decisions of participants, in banking or any other market. Regardless of how well intentioned the regulatory action, actors respond to it and position themselves in the market around that action.

Wingfield: Is there something about the regulation of banks that made it more likely that we would have this problem — or now that we have it, more difficult to solve?

Michael Mierzewski, Arnold & Porter: When we talk about banks it's important to draw a distinction between insured banks that are subsidiaries of bank or savings and loan holding companies, and investment banks and other kinds of financial intermediaries.

If you look at the insured institutions, where they are subject to heavy regulation — was there mis-regulation? Sure, perhaps the regulators were a bit slow to crack down on what became increasingly lax credit standards, for example.

But we also had a government — a central bank – that had a monetary policy of fostering cheap credit. When you foster a policy of making credit available cheaply, people are going to figure out ways to use that cheap money. Put aside for a moment investment banks and other types of financial intermediaries, I think you had companies that were growing to such size and complexity that regulators didn't have enough sophistication to understand them.

AIG was a savings and loan holding company that was regulated by the OTS. The head examiner of the OTS has testified in an interview that he just didn't understand the complexities of credit default swaps, for example.

So with the benefit of 20-20 hindsight, we see within the banking system regulators that were slow to react to the consequences of a lot of cheap money looking for ways to be deployed.

Wingfield: But can regulators ever keep up with financial innovation? And if they can't, is the solution to limit the banks ability to innovate financially? Or do you throw up your hands and say, "We can't regulate. We just have to manage the fallout when things go bad."

Alan Avery, Arnold & Porter: My view is that regulators can keep up with financial innovation. It's a question of resources and priorities within the agencies. Some of that is compromised because of the multi-regulator system in the United States, with both a federal and state level, where there is to some extent opportunities for regulatory arbitrage. Those seeking to engage in certain kinds of activities may seek out a lighter-touch regulator to allow them to innovate or — if you will, exploit — differences between the regulatory regimes.

I am speaking now of the commercial banking system, at the federal and state level.The question is how, practically, do you harmonize the level of sophistication across the regulatory agencies that have responsibilities for commercial banks? And that's a practical challenge due to the federal-state system, as well as the complex federal regulatory system among the various agencies.

Mierzewski: There is another side of the equation that we have not touched on yet. That is the unregulated side of the financial market. We had mortgage brokers that were in many cases totally unregulated and who, from my perspective after looking at thousands of loan files, cared about getting their brokerage fee, getting the loan closed and moving on to the next deal and didn't care about the risk inherent in any particular loan.

Then you had the explosive growth of mortgage-backed securities and securitizations, with the investment banking firms making money hand over fist. It became a situation where if you had a pulse you had a loan.

Then we had rating agencies, who — after someone took one bad loan and plugged it into a pool of a thousand bad loans — said we have a Triple-A rated security because we assume in our modeling that home prices are always going to go up. We assume that people didn't lie on their applications — even though people didn't verify income or assets. Yes, some people are going to default, but spread the risk among a thousand bad borrowers, you are going to have a Triple-A rated security.

Kenneth Bialkin, Skadden, Arps, Slate, Meagher & Flom: I think we agree this is the result of the perfect storm. We can make a list of the causes, and the list would probably be thirty lists. But now we are here, and the government is trying to get their arms around a very serious problem.

We have to recognize that the atmosphere of unrestrained leverage went beyond housing. We are now looking at a tsunami in commercial real estate. Some of the largest companies globally are beginning to file for bankruptcy. We know that the private equity world has huge amounts of private equity obligations, which the lenders can't collect and the borrowers can't pay.

Unfortunately everything comes back to the health of the banks. Why is this recession different from every other recession that we have experienced in our professional lives? We've experienced other recessions going back to the end of World War II. Those recessions were usually limited in cause to a particular industry or a particular section of the country, while other parts of this large economy we have weren't necessarily impacted.

Mierzewski: Yes, a good example is the recession that followed the tech boom — the tech bust — of the early 2000s. It didn't infect the entire global economy.

Bialkin: It didn't stop the country. The problem we have today is the credit system isn't working. The banks can't trade with each other because they don't trust the other guy's balance sheet. There is no money available even to go bankrupt! The reason there aren't more Chapter 11 filings of companies that are slowly going broke is they cannot get debtor-in-possession financing, and they are having to go into a liquidation. And liquidations means people stop working.

I think to the government's credit, they understand that until the system begins to work, until banks begin to function, we are not going to get our arms around the problem. This is why we have all the new programs. The government is trying to kick start the economy. The question is whether it's going to work, and if it isn't, how else to do it?

Botti: The lack of consistency in regulation led people in the markets to compete with each other either by, as you said, shopping for regulators or trying to compete with those who are un-regulated. But the other piece is not really about regulation so much as government intervention, or subsidy of economic activity. That was clearly well intentioned. No one was trying to create this situation.

But it is important to recognize that type of subsidy, even if it's intended to be short term, can have long term consequences for how markets behave. As we look to solve the current crisis — the lending crisis, the availability of capital — we want to think about these short term remedies and consider whether we intend them to have long term influence on how markets are shaped. Is the goal here, in getting through the short-term crisis, to fundamentally change, and maybe distort, the relationship between government and the markets?

Bialkin: That's a good question. But I look at this, the economy and the country, as an ocean liner in the middle of a sea. All of a sudden the engine stops, and the ship is adrift. Before you worry about the long term implications, you have to get the ship moving again. Banks are now reporting relatively good results for the first quarter. Why hasn't optimism returned? Some commentators, say, "Well, the banks are reporting profits, but you can't believe the banks' balance sheets. They are not properly valuing the assets on the balance sheet, and for all we know the banks are really insolvent, but won't say so."

We all hear that, and I think that's one of the most dangerous things you can have in a society. If someone thinks a bank is insolvent, it ought to be charged with insolvency. It ought to be faced. But to hear the rumors and the unwillingness to trust the banks – I think that is extremely dangerous.

The head examiner of the OTS has testified in an interview that he just didn't understand the complexities of credit default swaps.

Mierzewski: The government I think is taking very deliberate steps to get the banks functioning again. But the reality is, if you have assets that are not currently worth what their carrying value is, institutions are going to be very reluctant to take the hit.

Wingfield: Well, Paul Krugman says the solution is to nationalize all the troubled banks. Is it?

Bialkin: They are already. You don't think Citibank has been nationalized? Total market cap of the public stock is less, far less, than the 36 or 40 percent that the government owns. The government has achieved the result of nationalization without nationalizing. Does anybody think the management of any of these major banks really has the kind of discretion that directors and managers have in most companies? They will do what their regulator tells them do.

I don't think we should throw around labels, and ask whether nationalization is good or bad. Let's look at where we are. We have to somehow make what the government is trying to do work. And we have to make those assets real. And the only way — I hate to make it sound this way, but you used the phrase, assets on a balance sheet are worth less than their "carrying value." But that is the history of balance sheets. Does anybody look at any normal, healthy business, and look at the carrying value of the assets and say, "If we had to sell those assets tomorrow, could we get it?"

The healthiest businesses in the world couldn't realize their assets, in a short period of time, at the values they carry, and they couldn't pay the liabilities at the values at which they're booked. That was not the original theory by which balance sheets and financial statements were intended to give a picture of the health of the company. But unfortunately people are now saying, "Well, if it's worth less than they are carrying, why don't we make them show it?"

That brings me to my favorite flogging subject, and that's mark-to-market accounting. There are people who say that we are the victim of our own perfidy in taking our signal from accounting standard regulators who introduced a phrase which has no real meaning: "fair value." What do we mean by fair value?

The problem is the FASB adopted fair value as the standard by which financial companies — any company — has to report. I don't think they thought through the implications of that. I believe it was over-conservatism in third parties looking at balance sheets and saying, "Since you couldn't sell it for what you are booking it for, you're insolvent." But that's not what insolvency means. Insolvency means not that your assets are worth less than your liabilities, but that you can't pay your debts as they mature in the ordinary course of business.

Mierzewski: Didn't we see this in the bank regulatory world in the early 1990s when bank holding companies

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were required to look at their commercial real estate projects and value them at liquidation value rather than at values that would be achievable over a period of time?

Bialkin: I am led to understand that there was a very large amount of regulatory forebearance — that is people looking the other way on exactly what it is you are saying.

Mierzewski: We went through the savings and loan crisis, and the government issued net worth certificates to create imaginary capital. And that didn't work. And then the pendulum swung the other way, and the bank examiners went into banks all across the country and wrote real estate projects down to liquidation values, which created a lot of insolvencies, on paper.

Avery: Right now isn't one of the problems with the mark-to-market rules that there is no market for a lot of assets? Therefore it is not sufficient to mark it down to liquidation value because there is no liquidation value at all. So it's impossible to value the assets.

Bialkin: Well, that raises the question of what you mean, "mark-to-market." And whether or not banks should be subject to mark-to-market. And the answer is they're not, on certain assets.

Wingfield: Do we need more markets in more financial products? I'm thinking in particular of credit default swaps, which aren't traded in an active market, and other structured financial products that are not in an open market. Would it help us if we had markets for these products so there would always be, at least in theory, a market price for them, which could be traded?

Botti: That's a question for which I reject the premise. As a competition lawyer, I'd say that it's a question for the markets to sort out. I recognize that we have this current crisis that we are trying to navigate through in order to get capital flowing again. But when it comes to where the right equilibrium is after the markets are functioning again, I am personally and professionally skeptical about the competency of government to ascertain that.

What you want is to make sure that you have good clear regulations. The question of what kind of disclosures are appropriate is a good regulatory question. But once you have answered it, I think the markets will deliver to us, over time, the right number and character of financial instruments.

Wingfield: What happens, Mark, if the instruments are so complex that you can't provide adequate information about them? The credit default swaps are a good example, and as a result were badly mispriced. I don't think they were mispriced because people were stupid. It's just that they didn't know how to price them.

Botti: Let's back up. I think we have to ask the question, who are your consumers? You may want to regulate who can participate in certain very complex markets.

But I think you let the markets sort these things out. You have to come back to what got us here and not look at the immediate question of could these sophisticated consumers decide whether these products were ones they wanted to invest in our not. We talk about there being a perfect storm of events. So do you focus on this one event? What are we going to do, ban different financial instruments? Closely regulate them, because we think the regulators — who in the past were not able to keep up with these things — are now going to be able to do it? I think that type of government intrusion has longer term consequences that you have to be concerned with.

I have to come back to this, because we touched on it and moved away from it. There is a proposition that seems to be accepted, that Citibank has in some sense been nationalized already. That strikes me as a very big policy decision. A long term policy decision. It means there is a nationalized bank competing with other banks in the long term.

Government intrusion has longer term consequences that you have to be concerned with. We are having a similar debate about healthcare reform, in terms of whether to insinuate into the markets a government plan, and what affect that will have on private plans. We are not asking, "What are the long term implications of solving this short term crisis with the nationalization of a major financial institution?"

I understand the analogy of the ocean liner that's ground to a halt and you want to get the engines going. But that doesn't mean you fundamentally change the nature of the ocean liner.

Bialkin: I agree, in that I don't think it's up to government to fix and manage everything. But we have to find a way, through the leadership of government — because it's only the government that can suggest the means and techniques of getting us out of where we are — to try to provide the assets with which to do that. But they don't want to run the economy. They want to put it in a condition where we can restore some balance.

Mierzewski: I do think that unfortunately one of the things that comes out of crises is a tendency to overreact. And we see coming out of Congress legislative proposal after legislative proposal that may be designed in the short run to restore the stability of the banking markets that Ken has been talking about. But I think there will be a tendency to over-regulate, in reaction to that perception that there was either mis-regulation or under-regulation.

This notion of a "super regulator" to regulate the heretofore unregulated financial market players, something that the Treasury Department has announced, concerns me. I haven't seen many details about what the super regulator is going to look like, but I'd be very concerned if we concentrate a lot of power in one entity. I'm not against regulation, but when you talk about a super regulator, you need to consider who that regulator will be. An existing agency? Something created out of whole cloth? What will its mission be? How is it going to be held accountable? If I am regulated by a super regulator, I would like an avenue of appeal if I disagree fundamentally with a position that it's taking.

I'm just afraid that we are going to end up with some legislation or regulatory developments that are so restrictive that we will constrain free markets, in an overly conservative manner that stifles innovation and creativity. There has got to be a happy medium.

Wingfield: I too am concerned about that. Since financial liberalization began in the early 1980s, we as a society are vastly richer than we were in the period before the 1980s, when we were heavily regulated. That expansion was the product of increasing choice in how one manages finances and how one accumulates capital and manages risk. The suggestions that we increase regulation are really designed to reduce choice in order to manage risk. So the long term consequences I think will be lower growth, with us being worse off than we are now.

Bialkin: I sense an agreement that we all would be concerned if, as a result of this, we bring on an overlay of close regulation that impairs the ability of a free market system to function in a way that we think is good. I don't sense, though, that it's likely to happen.

We have a crisis now, and we have to put the fire out and get the market started again. Then we will have plenty of time to argue in the Congress and in the public arena. I do believe we can have a consensus that this is different than other recessions that we've seen, and the challenge we have to face is to get the financial system working again, so that credit begins to flow and businesses can develop confidence. You can't develop confidence by passing a law saying, "Have confidence." We have to support the motive and purpose of what the government, the Treasury – both before and after the election - is doing to try to get things started.

With the multi-regulator system that U.S. banks operate in, there is to some extent opportunity for regulatory arbitrage.

I would not underestimate what I characterized as the accounting issue. I think that has done a great deal to take the air out of the tires of the banks' balance sheets. Now people could say they deserved to have the air taken out of their tires. I don't think so. I think the essence of American society is that we live in a sea of credit, which requires confidence and respect for the rules of borrowing and repayment. We have to get back to that, to getting the banks back into a system where people respect their purpose, and respect their reporting, and stop criticizing their accounting. That would be an essential step on the road to recovery. EC

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