SEC HISTORICAL SOCIETY
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Bingham Presents: New World of Financial Regulation

THERESA GABALDON: Good evening and welcome to Bingham Presents, broadcast live from Bingham McCutchen LLP's offices in New York and online on www.sechistorical.org, the virtual museum and archive of the SEC Historical Society. I am Theresa Gabaldon, Lyle T. Alverson Professor of Law at The George Washington University Law School, and moderator for the program.

Bingham Presents is made possible through a partnership between Bingham McCutchen LLP and the SEC Historical Society. Bingham, with more than 1,100 lawyers in 12 locations including financial and regulatory centers such as New York, Washington, London and Tokyo, offers market leading practices focused on the financial services industry, encompassing everything from bank, securities and investment law and regulation, to financing, structured transactions and restructuring. The SEC Historical Society, founded in 1999, is a non-profit organization, which preserves and shares the history of financial regulation through its unique virtual museum and archive at www.sechistorical.org, accessible worldwide at all times. The Society and the museum are independent of and separate from the U.S. Securities and Exchange Commission. The Society is grateful for the support and assistance of Bingham McCutchen LLP in making this program possible.

Together we are presenting today a conversation about the new world of financial regulation. It's been over a year since the global financial crisis of 2008 began and the debate about the creation of a more effective financial regulatory system continues. It's our hope that at the end of the discussion, each of us, the presenters, the audience here at Bingham's offices, and those listening to the online broadcast, will have made at least a bit of progress in thinking about solutions for the problems that have affected us all.

I am delighted to introduce my distinguished fellow presenters representing the fields of economics, the media and securities regulation. To my right, Jesse Eisinger, senior reporter with ProPublica, a non-profit investigative news room in New York and formerly Wall Street editor of Conde Nast Portfolio as well with The Wall Street Journal; then, Roberta S. Karmel, Centennial Professor of Law, Brooklyn Law School and a former SEC Commissioner; and Joseph E. Stiglitz, Professor of Finance and Economics, Columbia University Graduate Business School, the Graduate School of Arts and Sciences and the School of International and Public Affairs, former Chief Economist at the World Bank, former Chairman and member of the U.S. Council of Economic Advisors and 2001 Nobel Laureate in economics.

Our discussion today will be an interactive one among the presenters with each asking questions of one another in and perhaps out of their fields of our specialties and forecasting a lively debate on such issues as centralization of regulation among current

and proposed government agencies, touching on why the United States has maintained a balkanized structure; bespoke derivatives; rating agencies; the impact of executive compensation on taking risk; and can and should an institution be too big to fail?

Before we begin our program, I would like to state that the views of the presenters are their own, and do not reflect those of Bingham McCutchen LLP or the SEC Historical Society. The Society is responsible for the selection of the moderator and presenters. We presenters have determined the questions that will guide the content of our discussion. I will begin the conversation over the question that you, Roberta, might like to start off on. Why does the U.S. have such a balkanized structure for financial regulation?

ROBERTA S. KARMEL: It is partly a question of historical accident in that various regulatory agencies were formed at different times, usually in reaction to scandals in the financial markets. But it is being maintained because of politics and in particular, Congressional politics. The different oversight agencies have oversight of different regulators and these oversight committees do not want to lose their jurisdiction. I think this is particularly acute with regard to the Securities and Exchange Commission and the Commodities Futures Trading Commission which have such overlapping responsibilities that have yet to be harmonized.

THERESA GABALDON: Joe, I think I see you nodding sagely down there.

JOSEPH E. STIGLITZ: What I wanted to say is that we should realize that having a single regulatory agency would not have prevented the problem. The U.K. had a unified financial regulator and they had just the same crisis that we did. So, I think that this has become more problematic as different parts of the financial structure are producing similar products. So, you have insurance products produced by insurance companies and by securities and regulated differently, and because they are regulated differently that creates opportunities for regulatory arbitrage. I think that's why there is consensus that we need to have some institution that's looking over the whole regulatory landscape. But because the institutions are still marketably different, I mean the insurance industry is still different from the other aspects of securities industry. I don't think we are going to necessarily move away from separate regulators for the different institutional structures as long as they are coordinated. I don't think it need be a disaster.

ROBERTA S. KARMEL: Well, there's a big difference between a unified regulator as the U.K. has and as many regulators as we have in the U.S., particularly regulators that in fact are regulating the same businesses. It's true, banking, investment banking, insurance, commodities are different businesses and they do not necessarily need exactly the same regulation. But you don't need the great number of regulators that we have and it does permit financial institutions to choose their regulators.

JOSEPH E. STIGLITZ: That's right. There is a framework that I think is an interesting one is the one that Poland has gravitated to where they have an overall financial regulator. But under that they have separate, you might say, commissions that

developed regulations for each of the institutional structures so that they try and have comprehensive regulation to prevent regulatory arbitrage, the kinds of problems where you look for the least regulated part. On the other hand, they have enough institutional knowledge of the differences between the way the insurance markets work and the way the banking institutions work, that institutional background doesn't get lost.

JESSE EISINGER: I am a journalist, so I am good at asking questions and you wanted us to ask questions. I throw out a question because now it looks like Congress is going to head towards giving us more regulators on top of all the regulators that we have. I think maybe the OCC will be folded into other banking regulators, but we are going to get a new consumer products regulator, a financial products regulator and then we may get some kind of systemic risk regulator or at least a panel, which really invests me with a lot of confidence when I hear the word "panel." I am wondering if you have any confidence in what's being molded right now.

ROBERTA S. KARMEL: I think having more regulators is hardly the way to go. We should have fewer regulators. On the other hand, I think a new systemic risk regulator probably is a good idea. But it depends on what such a regulator would really do.

JOSEPH E. STIGLITZ: I think the issue is more or less a structure of the whole regulatory system. I am non-enthusiastic about having the Fed become the single regulator. Have we made a regulatory reform that is likely to prevent another crisis of the kind that we have just had? We should remember that the Fed had more powers that it used to before the crisis. Now we're saying we are going to give them even more powers; that doesn't seem to be the way to solve the problem. One of the arguments for the Financial Products Safety Commission is that you would have a focus on the consumer. The regulators would not be chosen from the industry, but from the people who will be hurt if the industry doesn't do its job, and therefore, you have a different incentive structure, a different set of players at the table. I think that can make a positive contribution. I think you do need to have something like the financial stability regulator that has to look over the whole system. The particular institutional structure is a question that is very difficult, but clearly those are different functions and I think you need to have different regulators focusing on those different functions.

ROBERTA S. KARMEL: I know in a panel like this we are supposed to disagree, but actually I do agree. The Fed should not be the financial systemic regulator at least not as long as it also has the job of prudential regulation and monetary policy. I think those three regulatory functions are in conflict with one another. In particular, I think there is a serious conflict between prudential regulation, that is the responsibility for making sure that individual financial institutions have adequate capital and are not on the verge of collapse, and worrying about the entire system. I think those problems were quite apparent in this meltdown that we are still going through. Would a prudential regulator that's responsible for the health of the individual financial institution say, "Well, we don't think there should be any more derivatives trading or structured finance because that's a danger to the whole system when that particular financial institution is making big profits in this market?"

JESSE EISINGER: I will play devil's advocate for entertainment purposes and say that I think that all this focus on structure doesn't focus on regulatory confidence and attitude. If you look at two of the biggest SEC failures of the last several years, first, the obvious failure, which didn't have anything to do with the systemic problems, is Madoff. Now, that's not a question of regulatory powers, it's not a question of balkanization of our regulatory structure, it's a question really of competence at the SEC. The second issue was an issue where the SEC lifted leverage standards in 2004 of investment banks, which led to systemic problems. There again, that's not an issue of playing the CFTC off the SEC, that's a question of a will to regulate. We had a problem not only of de-regulation but of un-regulation. We had somebody like Harvey Pitt, who came in as the Chairman of the SEC, but really had an attitude of being against regulation; we had Chris Cox, who as far as I can tell, had an attitude to pro-sleep. All the structure in the world can't really remedy these problems.

ROBERTA S. KARMEL: I think there's been a lot of misconception about the leveraging of the five investment banks that were subject to the SEC's consolidated supervision. The SEC did not really change the net capital rule. These banks were in compliance with the net capital rule. Lehman Brothers was in compliance with the net capital rule when it went under. The problem was that many risks were transferred from the investment bank to the holding company or to other subsidiaries. This is the same exact thing that happened at AIG. It wasn't the insurance company that had all these systemic problems. It was some subsidiary off in the U.K. that had these toxic assets. The SEC program was a voluntary program the SEC took on because of pressure from the EU and other quarters to be the consolidated supervisor of these investments banks. Now I would concede that there were problems in the way in which the SEC administered this program. But it's not really the case that the SEC changed the leverage requirements under the net capital rule. It is the case that the holding companies of these investment bank holding companies became unduly leveraged but so did a lot of banks and so did AIG.

JOSEPH E. STIGLITZ: I think there are two issues here. The substance is, as you say, we allowed them to get more leverage than they should have. We think of leverage at 30% and in a bubble a 3% change in the value of the assets throughout and you ask 3% and real estate prices are 30%, 40% correction, you were really gambling and we allowed it and we should not have done that. You can say that's a regulatory failure. I think the problem of regulatory capture is persistent, is a real problem and the question then is, how do we respond to it? It seems to me there are basically two or three ways to respond to it. One, realize that there is going to be regulatory capture and therefore give the regulator less discretion. That is to say, you have rules that are stronger, that give less scope for the institution regulator being captured, you hardwire. So, whenever regulatory reforms are being discussed, whenever you say, when you see rules that say, "We will ask the regulator to give adequate leverage, you should be worried because that's a cover to say, in five year's time Bernanke or whoever the regulator today has had their fingers burned. In five years time we will forget about it and we will go back to business as usual." That's the first. The second one is to make sure that those who are

responsible for the regulation are among those who are going to be heard. That's the arguments for the Financial Products Safety Commission, so you create incentives. And third, I know this goes very much against the argument for regulatory simplicity, but I think that there are arguments for multiple regulators. In the area of competition policy, we have multiple regulators. We use both the private and the public and the reason we have private enforcement event, I trust, is when they passed it, they were aware of the problem of regulatory capture, as we have seen those who have watched what happens to competition when the big monopolies try to shut down public action in this area. That's why we have tried to hardwire a private enforcement action. So it seems to me that we need to think of ways to protect ourselves. And the basic lesson here, I think is the cost of regulation is miniscule compared to the multiple trillion dollar losses of one failure. We have had more than one failure; we had many bailouts of our financial system.

ROBERTA S. KARMEL: I have a different prescription, or I should say, an additional prescription for the problem of regulatory capture. It's not very realistic but I think it's the heart of the problem. I would say what is needed is campaign finance reform because the capture comes in through Congress.

JOSEPH E. STIGLITZ: I agree. Hold on. I totally agree.

JESSE EISINGER: The media is the other way. We should have a pony for everyone in the room. But everybody agrees, campaign financing reform might be good. I would just add one thing which is that, if you are calling for less discretion on the part of the regulators, that's the exact opposite of what's happening right now with Barney Frank's proposals and Geithner's proposals on capital regulation. What they are going to do is say to the regulators, "You guys have to figure out standards to tighten up bank capital requirements. You will tell the banks what they are." You were going to give the regulators a lot of discretion to try this enormously difficult problem and it is going to be out of the public view largely and I think its reason for pessimism about what comes out.

ROBERTA S. KARMEL: I am very pessimistic about our fractured and captured Congress coming up with rules for complicated issues like capital adequacy of financial institutions.

THERESA GABALDON: I have a question for Jesse. I am hoping to take on the issue of when is something too big to fail and the issue of bailouts which you have already raised. Jesse, what is the role of the media as far as addressing regulatory capture and addressing the problems of multiple regulators?

JESSE EISINGER: Make jokes.

THERESA GABALDON: And they do it well.

JESSE EISINGER: The media's job is to hold people accountable for their decisions, to bring in to the public light these kinds of issues. It's extremely difficult with issues like

capital adequacy for banks or derivatives or the shadow banking system because the journalists are so typically outmatched by the complexity of these issues. I think, just as I was talking about regulatory attitude, the media needs an attitude of being much more antagonistic about the subjects that they cover. The business media in particular tends to be much more acquiescent about business topics. I don't think that most business journalists got into journalism because they wanted to right societal wrongs. I think many of them stumbled into it and so I just don't think they have this kind of oppositional attitude that we have to have. You have to be unafraid of complexity and have time to understand issues, while also being outside of them, so you are not captured, as it were, by the interests that you are covering. A lot of business journalists serve the interests of investors rather than serving the interests of the public. It's a subtle form of capture in journalism and if you look at the journalism landscape, the people who are hiring now are Reuters and Bloomberg, services that largely provide information for investors. They do some fabulous journalism there. But the main audience is elite investors paying an enormous amount of money for it. The institutions that are downsizing are institutions that historically have not been for investors and they are in trouble. So we have a crisis in journalism that's only going to get worse.

JOSEPH E. STIGLITZ: I agree very strongly the press has a very important role and I think we have to have legal frameworks that give the press more access to information. One of the big issues over the last few months has been over whether the Fed is subjected to the Freedom of Information Act, whether it's a public institution that is accountable to people. Bloomberg sued; the Fed said we are not a public institution and are not accountable through the Freedom of Information Act; a judge ruled in August that they were. It's not clear whether they went and appealed but I think that's very important. One other aspect of the regulatory structure that goes with the issue of competence that's important is a concern about salaries. And this is worse in other countries than the United States that the disparity between the salaries of the regulator and the salaries of those who are regulated creates an imbalance. And again, one of the interesting approaches is one taken by Poland, where they have indexed the salary of the regulator to the salary of those in the financial sector. They have a tax imposed on the financial sector that is based on the salaries and if the salaries in the financial sector go up, so do the salaries of the regulator. I think it's an interesting idea to keep a little bit of a level playing field over here.

THERESA GABALDON: I know some people who would like that.

JESSE EISINGER: Of course the revolving door should be closed down so that regulators can't join law firms and banks for years after they have been regulators. I have a question which is that, one of the problems with the SEC in my view is that it's too filled with lawyers and doesn't have enough market expertise.

JOSEPH E. STIGLITZ: Economist.

JESSE EISINGER: I meant economist.

JOSEPH E. STIGLITZ: Be self interested.

JESSE EISINGER: Do you agree with that critique and do you think that, if they had more market practitioners, that it would lead to more competent regulatory regulation?

ROBERTA S. KARMEL: The securities laws are very complicated and the SEC has always been a lawyer-dominated agency. There has long been this view that Commissioners and staff should be a mix of lawyers and other people: real people, economists, accountants. In my experience a Commissioner who is not a lawyer has a hard time really controlling the staff. On the other hand, what I think the Commission needs these days, not so much fewer lawyers or economists, but IT talent. The SEC needs much better technology, more IT people and better computer systems. The government is very backward compared to industry. How can you surveil the markets with inadequate technology?

I also think the Commission needs more people who understand the markets. Now the problem with us you might say is, "Oh, that's a revolving door. People come from Wall Street, they are going to go back to Wall Street." But if they don't come from Wall Street, they just come out of college or law school, they don't have any kind of a deep understanding of the markets. When I was on the staff of the SEC in New York in the 1960s, we had lawyers and we had investigators. A lot of these investigators were men, and they were all men in those days, who had come from Wall Street, some of them had gotten into Wall Street in the '20s, the '30s; then they came to the government. A lot of them were not very well educated but they had street smarts. They understood the brokerage business. I learned so much from them and I don't think you have this type of person any more at the Commission: someone who comes from a financial institution and really understands what goes on in the markets and financial institutions.

JESSE EISINGER: People think it's crazy to say but I think you needed somebody like retired hedge managers at SEC, have a crook to catch a crook like…

ROBERTA S. KARMEL: Joe Kennedy.

JESSE EISINGER: Joe Kennedy, you are right. What that leads you to is this disappointment in this generation of financiers because there doesn't seem to be anyone who has stepped up with the kind of service-minded, wise man or woman stature to really be able to get hold of this crisis. You have people like Rubin who used to have that kind of reputation and his reputation has been destroyed. Paulson's reputation is in the balance as we are debating it now and will be for years. But you really just haven't had anyone step up and really provide this kind of leadership either in the regulatory arena or as a figure to help us through this crisis.

THERESA GABALDON: I think I would like to pursue the subject of too big to fail and bailouts for at least a few minutes. I am going to start by asking Joe, what does economics tell us about bailouts, if anything?

JOSEPH E. STIGLITZ: First off I would like to say, what we have done in the last year is beyond anything that any economic text book had ever described. We have gone beyond too big to fail to a concept too big to be resolved. Too big to fail is the notion that you have a bank that you can't just let it fail. You will come in and save the institution but you have the shareholders who lose their money and possibly the bond holders; you have a usual process of bankruptcy but adapted for the particularities of the financial institutions. But we have gone well beyond that in the way that we saved Citi and Bank of America and even Bear Stearns. We have really extended the safety net beyond too big to fail. And my view is that there has been no convincing argument that any of this was ever needed. It was based on the notion of fear and that if you didn't do it, the whole financial set of markets would fail. Economics would have suggested if you did it, a debt to equity conversion then for some of the institutions the amount of, if you converted the long term debt into equity the financial institution would be well capitalized, there would be no reason to panic and that there would be more confidence in the market. But what is true is that we were in uncharted territory and so no one could predict with confidence what would happen and those who saw an opportunity to use scare tactics to get what they wanted did use those scare tactics and it worked in that sense. The consequence is of course that our national debt is going to be much higher than it otherwise would have been. Now there's another aspect of the bailouts that I think coupled by their aspects, as far as I can see, I haven't seen any justification. One of them was the terms when we gave them the bank's preferred shares, we gave them money and we got back preferred shares. The terms that we got on those preferred shares, I mean how many preferred shares that we get when we gave them. The Congressional Oversight Panel pointed out that in the first set of transactions we got at the time assets that were valued about 67 cents on the dollar. And those were assets that no one else would have bought.

JESSE EISINGER: Actually Warren Buffett got much better terms a few weeks ago; he did buy, but from Goldman, and he got much better terms from them.

JOSEPH E. STIGLITZ: Exactly. And the U.K. did it much better. I mean, we really got cheated. In the more recent ones we probably got as much a 25 cents on the dollar. It's very hard to see any justification for this tax payer robbery, to put it in graphic terms. The second one that has never been adequately explained is AIG. Now, there are two parts you can see difficult to explain. The general principle, we extended the safety net from commercial banks to investment banks with Bear Stearns. I think that was hard to justify but when we extended to insurance companies it was even more difficult to justify. The argument was that if we didn't do it there will be the risk of systemic failure. When we finally got from the Fed where the money went, the list of institutions, the first was Goldman Sachs which publicly said it didn't need the money. The next two or three were foreign banks and if there was a problem the foreign governments should have been responsible for it and make a judgment about whether there was systemic risk. And the largest one after that was $5 billion out of a $180 billion went to AIG. You have to ask really what was going on. And then making it more problematic was when they settled the AIG, when they cancelled the credit default swaps, my understanding is that it's like canceling insurance policy, normally when you cancel the insurance policy you

don't pay the insurance as if the house had burned down. In fact most of us scramble when we have our insurance policy, but that's what the U.S. Government did with Goldman Sachs, they gave them $13 billion and other contracts that were being settled were getting about 13% of that amount. And that's never been explained so far.

THERESA GABALDON: Roberta, are you similarly unimpressed?

ROBERTA S. KARMEL: I don't think we should have firms that are '"too big to fail." Since 1970, there has been a system in place for protecting customer funds and securities of broker-dealers through the SIPC Fund. The securities industry had to premiums into that fund, since it was an insurance fund like Federal Deposit Insurance. And so long as customer monies and securities were safeguarded, if a firm was reckless with its capital, it went bankrupt. Some of you might remember Drexel-Burnham, a large firm that went bankrupt. If we are going to have some concept that certain firms can't go bankrupt, we really need resolution authority outside of the bankruptcy courts. It should be with the FDIC or some other federal regulator. But if firms are not allowed to go bankrupt, then they shouldn't be allowed to conduct themselves in risky enterprises. In addition they should have to pay insurance into some insurance fund. Why should the tax payers be stuck for their failure? I think if some of these firms are too big or too complicated or too connected to fail, they should be broken up. After the 1929 stock market crash, the SEC was given the job of dismantling the public utility holding companies. There's no reason why today's big complicated firms can't be broken up, other than political will.

JESSE EISINGER: I agree with you both. What's interesting to me is that there is a crystallizing conventional wisdom certainly out of Washington that it worked. It was ad hoc, it was messy, it was poorly planned but in the end all this fumbling from Bernanke and Geithner and Paulson ended up working and the evidence largely for this in my view is the stock market is up. I think that people generally have this idea that the stock market represents the economy and is the daily barometer of our health and so they see, well, the stock market is up from its lows by 50%, so everything must be okay. But I think it's a very dangerous consensus forming about too big to fail because the regulatory reforms that we are discussing do really virtually nothing to address it. Geithner argues that resolution authority will have debt to equity swaps and so that will be prevent too big to fail and then potentially some capital requirements will go up disproportionately with size so that bigger institutions have higher capital requirements than they would otherwise have. So maybe those are hopeful signs but if everybody is thinking that these gifts to Wall Street banks really got us out of the crisis then it's not very hopeful that they will address this in any serious way.

JOSEPH E. STIGLITZ: I very much support the view that if they are too big to fail they are too big to be. These banks trade on their proprietary account with the U.S. taxpayer backstopping their gambling. There is no logic behind it and there's no economic benefit that comes from much of what they are doing. Now there maybe certain kinds of trading where that is not true, but for much of what they are trading there is, as economists would say, no economies of scope, there is no economies of scale that would justify the

social risk and the distorted incentives. One of the important points to realize here is that, that in a sense the incentives that we are having is continuing tilting the field in the wrong way because if we don't have a tax to fully pay for the cost of the insurance, we are subsidizing them. If they are subsidized then they grow and as they grow they get bigger, as they get bigger it becomes the problem too big to fail gets even worse and the way we have resolved the institutions in this case makes the problem even worse. So that we have a dynamic here that means over time we will get a more concentrated banking system and it will make things more difficult.

JESSE EISINGER: You think that there is more systemic risk now then last year, a year ago?

JOSEPH E. STIGLITZ: Yes. Very much so. Things are much worse now then they were a year ago. People have had their fingers burned so they are behaving a little better right now but structurally things are worse. And the notion the problem was economic, we need to give them economic resolution powers. I think it's a step in the right direction. I mean legal resolution powers that they have talked about. The point was, they had the power to make debt equity swaps. They could have forced Citibank to accept a debt equity swap. The reason they didn't do it was the fear of the economic consequences, I think was a misjudgment but it was their fear. So once you get these large institutions, its not the legal powers of resolution, it's economic consequences of not bailing them out and that hasn't been resolved, that's gotten worse.

JESSE EISINGER: Just to underscore the point. We had a massive credit bubble in the world and we punished equity holders here and there. But in almost no instance were creditors or counter parties stung at all except for Lehman Brothers and Washington Mutual and the Lehman Brothers case so terrified the regulators that they vowed never to do it again.

THERESA GABALDON: Somebody said something about counter parties. I think that may be your cue to talk about derivatives. Roberta, what should we do about regulating derivatives?

ROBERTA S. KARMEL: This is a very serious problem and I don't think we have really come to grips with it. I think that from a regulatory point of view derivatives were one of the causes of the meltdown. I should add that there were economic problems here that we haven't solved, such as our budget deficit and our trade deficit. You don't have these kinds of market collapses without something going wrong in the real economy. But in terms of regulatory failures, I think that our failure to regulate derivatives in any meaningful way was one of the key causes of the meltdown. This problem goes back to the 1987 stock market crash which occurred because of something called portfolio insurance – another name for that day's derivatives trading. Then you had Long Term Capital Management that was a crisis in the stock market because of derivatives and the regulators did nothing. After these two crises, which were warnings, little was done and I don't think that enough is being done now. In 2000, Congress in its infinite wisdom exempted credit derivatives from regulation by either the SEC or the CFTC or anybody

else. Why? Because Alan Greenspan thought derivatives were good. They were good for the balance sheet of banks, they spread risk well. Yes, they spread risk -- to you and me as taxpayers. I think that we can't really abolish derivatives. That would be as unrealistic as campaign finance reform. But I think we have to take a very hard look at the defects in our regulatory system with regard to derivatives.

JOSEPH E. STIGLITZ: Can I make a point that relates to some of our earlier discussion on the issue of discretion versus you might say hardwiring the regulatory structure? Because what the administration as I understand has said so far is that they want to encourage most of the credit default swaps be traded over exchanges, where there will be adequate margin. But they want to keep a window open for over the counter derivatives. Now this goes to the issue, if you really felt confident that they were going to manage this well and say we are going to have much higher margin requirements, make it much more costly to offset the lack of transparency and the difficulties. Then you might say, well maybe that might work. But this goes to the problem of regulatory capture, you know what's going to happen with a high probability is that the advantages of lack of transparency from the market participants is going to mean that much of it and you might say the worse part will trade over the counter. What makes it even worse in my mind is that the main institutions doing over the counter are, we are underwriting these. We may not know it but we are the counterparty because in effect they are being done by too big to fail banks and if they write and they fail we pay. So it seems to me that as an example of a simple regulatory reform, we ought to say is no to over the counter written by any financial institution with depository insurance that doesn't cover this. There is no reason why the money that we put into a deposit account that's insured should be mixed together with a gambling of that kind. No too big to fail institution should be allowed to write these over the counter because just think about it, would you rather write by a credit default swap with somebody who you know the government's going to bail out or with a small hedge fund? It's clear, it's all going to gravitate to the too big to fail and there we are going to be back with the problem we had but even worse.

THERESA GABALDON: Jesse, what do you think the person on the street needs to know about derivatives and how they are regulated or should be regulated?

JESSE EISINGER: They probably should learn the definition of bespoke. These issues are extremely complex for the average person and I don't think average people are going to understand synthetic collateralized debt obligations. I am not sure I understand them. But I think what the average person understands right now is they have a general sense that the banks were bailed out. They have a general sense that things are rotten with the economy. They have been undergoing a very slow moving quiet recession for really the decade as median incomes have fallen in this country and they are very angry, they are conflating all sorts of issues with the stimulus package and the bank bailout. So the average person doesn't understand anything about what's going on in the economy, they are very angry and derivatives is the 98th thing on the list for them to understand. But I think generally the sense that the banks are getting a very good deal and they are

not is the right sense. I just think its being expressed angrily and against the wrong targets frequently.

ROBERTA S. KARMEL: Maybe the public could understand that you bought a house that you couldn't afford that's been foreclosed on, so you are homeless because of derivatives.

THERESA GABALDON: I think that they probably should be a little outraged about that and I think they also should be a little outraged about credit rating agencies.

JOSEPH E. STIGLITZ: Can I just say one more thing that they should be a little bit outraged about which, well lots of things, but one of them is that the financial institutions said they were creating products to help manage risk. And they said that the reason we deserve such high salaries is that we were doing these things to make our economy so much more efficient because we were managing risk so much better. They failed in managing risk but it was worse than that, they actually created risk and they created products that made it more difficult for ordinary Americans to manage the simple risk they confronted, even though it was a risk of home ownership. And there are other financial products out there that could have helped them manage the risk of home ownership. Other countries have done better. Now the Danish mortgage bond is a system, a financial product that for 150 years has provided stability to those in Denmark. What they understand in a way is the banks have been taking advantage of them in credit cards and mortgages. But what they really want to think about is, why can't we have a financial system that does what it's supposed to do? And I think we ought to be switching that eventually from the naked of attack to let's try to create a financial system that actually does the things that financial systems are supposed to do.

THERESA GABALDON: You mentioned executive compensation, saying that people were rewarding themselves handsomely as this was going on. Has the behavior of individual firms actually been affected for better or worse by executive compensation?

JOSEPH E. STIGLITZ: Well, as an economist, if the answer is no, then our profession is really in bad shape.

THERESA GABALDON: Just what I was thinking.

JOSEPH E. STIGLITZ: If you are going to say incentives don't matter, I don't know, I will have to get another profession. So, the notion that were having incentive structures that were so distorted and would predictably lead to shortsighted behavior and excessive risk taking, seems to me fundamental in understanding what has happened. In fact, in the run up before the recession, before the crisis I felt a little bit nervous because I had kept predicting that these incentives structures should manifest themselves in a problem and it wasn't. I mean it was but it wasn't yet transparent that it was and so in that sense I feel relieved that we are now experiencing this because it does confirm the basic precepts of economics that if you give bad incentives people behave badly. Two points, one related to the SEC, I will mention very briefly which is, in

a way the discussion about the issue of stock options and expensing of stock options which provide incentives for, paid by stock options which is a particular part of this and one part which was something that was discussed in the '90s and the SEC finally giving in on that issue, not fighting it. He was under tremendous pressure and Congress was trying to do it, administration, Rubin and others in the administration had been pushing against the FASB Rule for expensing.

ROBERTA S. KARMEL: Chris Cox.

JOSEPH E. STIGLITZ: What?

ROBERTA S. KARMEL: Chris Cox was in Congress fighting against the expensing of options.

JOSEPH E. STIGLITZ: Yes.

ROBERTA S. KARMEL: And Congress threatened, "If the FASB does this, we are going to abolish the FASB." You can't really stand up to that kind of thing.

JOSEPH E. STIGLITZ: I agree, but the administration was also involved. The Council of Economic Advisors, that was odd, was one of the few people fighting on that issue because we thought this was valuable information and we agreed with what FASB was doing. What I just wanted to point out that this issue of executive compensation in a way is an issue that goes back a long way and it's still that aspect of it has not been joined. And the reason why I mention that is, the problem is not just in a financial sector, it's really a broader issue of corporate governance and its one that we really need to address.

ROBERTA S. KARMEL: But where did the pressure initially come from for payment of officers and directors in stock and stock options? From institutional investors who said to corporations, "You shouldn't really pay executives in cash. You should pay them in equities so they have skin in the game." And that's where the pressure initially came from. So this goes back to a comment that Jesse made before -- the pressures that come from institutional investors are not necessarily the same thing as the public interest. And this is an area where I think the institutional investors did everyone a disservice.

JESSE EISINGER: Stock options turned out to be a disastrous fix. But the issue of executive compensation or compensation at the Wall Street banks is not just an issue of the top executives, it was an issue that went down throughout the firm. And I think that in the discussion of just sort of trying to give guidelines for the top executives who were missing some of the problems. And I give you my favorite example of this which is that traders did a trade called the negative basis trade, complex trade but I won't get into details, I am sure I don't even understand the details but it was essentially a perfect hedge, a supposedly perfect hedge.

ROBERTA S. KARMEL: There are no perfect hedges.

JESSE EISINGER: Right. Which actually wasn't perfect but allowed the trader to book a profit. But because it was supposedly a perfect hedge and because of, it was profitable because of the derivatives market was less efficient than the underlying bond market. The trader booked a profit because it was a perfect hedge, the trader would purposely have a long dated contract and then get to take the present value of the trade as profit. So a 40-year contract, it was a perfect hedge there was no risk, the bank decided, the accountant signed off on this, the derivatives market was inefficient and so it looked profitable. And they got to take this massive phantom profit and take a cut of the massive phantom profit. So it was a completely dangerous, reckless trade where every single thing failed, the derivatives market failed, the efficient accountants failed, the internal risk management failed and the trader was responding to incentives as the commentators tell us, here she will in taking a massive gain. So, these are the kinds we are dealing with, with Wall Street competition, it's a very difficult problem and won't be solved by a few gentle guidelines from the Federal Reserve.

THERESA GABALDON: We have just about three minutes left and I am going to insist on pressing each of you for a minute's worth of wisdom on my favorite topic, credit rating agencies, starting with you, Jesse.

JESSE EISINGER: Sure. Well, the credit rating agencies were also at the heart of the problem and they were taken advantage of and by the banks that used them to sell AAA products. The worldwide demand for AAA products around the world drove a lot of the securitization and the credit rating agencies drifted because the money was in structured finance, the profits were in structured finance. So they drifted away from plain vanilla municipal bond rating and corporate bond rating which was less profitable. They should be stripped of their self regulatory status by the government, I think and Barney Frank has actually said this. He said the credit rating agencies have no friends in DC and so he's going to do this and he wants to strip them out of all sorts of rules and regulations because lots of investors are required to look at credit ratings in order to buy. One wonders why are the rating agencies preserved, so protected by DC and the answer is that the Wall Street banks want the rating agencies because if they didn't have them then they would have to go out and sell corporate bonds themselves to investors who would really have to understand them and that would throw the whole system into disarray. And so Wall Street banks want the rating agencies, so I am very pessimistic that even though Barney Frank says everyone in Washington hates rating agencies and they are going to get rid of them or strip them of their status that anything is going to get done there.

ROBERTA S. KARMEL: I think it's a very difficult problem. I don't know that it really is a good idea to say, all right there will be no more credit ratings on bonds, because ratings are important not just with regard to corporate bonds but also with regard to municipal bonds. I don't know how retail investors, who nobody seems to care about anymore, are supposed to know what bonds they can buy if there are no ratings. I think that the credit rating agencies should be subject to liability under Section 11 of

Securities Act of 1933 so that they have to do due diligence the way underwriters are supposed to do before they give a rating. They have escaped this in part by saying, “Oh, a rating is just an opinion and we are protected by the First Amendment.” I think that construct has to go. So, that’s my one minute or whatever we have on the subject.

THERESA GABALDON: I was going to say, we are just about out of time. Joe, I am going to ask you to just say whether you think you will be closer to Jesse’s position or Roberta’s.

JOSEPH E. STIGLITZ: I would be closer to Jesse’s position. I had really serious problem with conflict of interest, they believed in financial alchemy, they convert affiliated securities into A rated, good enough to be held in a pension fund. They clearly didn’t understand the economics of what they were doing and so I don’t think they in the end added value; they really subtracted from it.

THERESA GABALDON: Thank you. Roberta, Jesse and Joe, thank you for being here today. On behalf of the SEC Historical Society, I would also like to thank Bingham McCutchen LLP for its generous support and assistance in making today’s program possible. It’s been a privilege to partner with you. The audio of the program is now available on www.sechistorical.org and a transcript will be available soon. Thank you again to our audiences both here at the Bingham offices in New York and online at www.sechistorical.org. Good evening.