# Filling Gaps and Dark Holes:
# Restructuring the Financial Regulatory Apparatus for the Next Crisis

Written Testimony of Steven M. Davidoff[*]
Prepared for the U.S. Senate
Committee on Homeland Security and Governmental Affairs
January 21, 2009
"Where Were the Watchdogs? The Financial Crisis and the Breakdown of the Financial Governance"

**Introduction**

Chairman Lieberman, Ranking Minority Collins, and other members of the Senate Committee, I would like to start by thanking you for giving me an opportunity to testify at this hearing to review and assess the adequacy of the current structure of the U.S. financial regulatory system.

Before turning to the substance of my testimony, I would like to summarize the important themes:

1. *The Current System is Fractured and Archaic*. The current financial regulatory structure is a quilt work of nine primary regulators with sometimes differing and overlapping responsibilities.[i] It is not structurally capable of regulating today's complex, interconnected financial markets. The current regulators should be consolidated into three regulators: a financial markets regulator, bank capital regulator and systemic risk regulator. To the extent full financial integration is not politically achievable, Congress should create regulatory champions in each of these three areas who can dominate the remaining other regulators and grow and absorb them or their responsibilities over time. The recommendations in this testimony are goals to be fulfilled over time and phased implementation may be the most politically feasible route.

2. *Private Markets Should be Subject to Increased Oversight*. The private and quasi-private markets now overshadow the public equity markets in size and scope. For example as of June 2008, the private over-the-counter derivatives market had a notional value of $683 trillion.[ii] Meanwhile, hedge funds, private equity funds, endowment funds and other capital pools exist and invest largely free from the oversight of any financial markets regulator. It is estimated that hedge funds alone have approximately $1.5 trillion in assets under management, a figure that was a higher $1.9 trillion in the prior year.[iii] Given the role of the "private markets" in the financial crisis and their significant size, any future financial regulator should have oversight authority over the trading and issuance of securities, including derivatives and credit default swaps (*CDSs*), throughout the entire financial market, both public and private.

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3. *Filling Regulatory Gaps and Black Holes*. Any systematic regulatory reform must encompass the entirety of the financial system. It cannot leave gaps, black holes (i.e., deliberately unregulated areas) or financial institutions without potential oversight. Otherwise regulatory arbitrage will be possible. In particular, any systemic risk regulator should have potential oversight over the entire financial market and all financial institutions, including insurance companies, should be subject to financial regulatory oversight. Exact capital requirements imposed on financial institutions, if any, should be decided through the regulatory process undergirded by cost-benefit analysis with regard to the systemic risk and with reference to the Basel II standards as they may be reformed. The possibility should remain, particularly in the case of insurance and banking, for continued, delegated supervision through state regulators subject to appropriate monitoring.

4. *Regulating Forward Not Backward*. In each crisis there is a tendency to regulate to the past problem and not the future. But the mistakes of the past are unlikely to be repeated soon; in the next crisis the unknown mistakes of the future will again stress-test the system. Moreover, the financial revolution continues to allow for more sophisticated and different financial products. Any regulation must bestow regulators ample authority to adjust their regulation, and respond to modern developments and the ability for regulatory arbitrage. Congress should focus on building "flexible regulators" which have the institutional capacity and jurisdictional scope to respond to future crises and developments.

5. *Regulating Politically and Feasibly.* In building "flexible regulators" Congress should focus on building a sustainable financial architecture but should leave the details of specific rules to be filled in by the selected regulator. Otherwise, Congress risks erecting rules that are either not adaptable to future changes or are not fully informed by later research on the financial crisis and our capital markets. Moreover, by focusing on setting up an apparatus rather than writing entire regulatory codes, Congress will forego getting stuck in the mundane details and missing the opportunity the financial crisis presents for regulatory reform. Of course, in particularly important areas Congress may still choose to mandate a particular outcome.

6. *Relevancy of the Current Crisis*. The root cause of the current crisis appears to have been inordinately low interest rates which created a credit and liquidity bubble and led to undue leverage and risk-taking by both individuals and financial institutions who believed that "housing prices never go down". The collapse of this bubble has exposed many failings of the U.S. regulatory architecture. Regulation should address these failings but realize that the panic of Fall 2008 was based on a series of events itself based on a misheld belief and economic policy. Accordingly, regulators provided expanded jurisdiction should be careful to regulate in a way that accounts for the extreme stress placed upon the system by that collapsed bubble and fixes the faults exposed but does not over-compensate.

7. *Setting the right balance*. In regulating, Congress must remember that the prior system, despite all of its faults, led to the United States becoming the capital center of the world. Any future regulation must allow for the continued development and preeminence of the U.S. financial system in a globalized world. Here, I must emphasize that when I speak of providing "oversight" responsibility, it does not necessarily equate with heightened substantive regulation, but the potential for regulation if a regulator exercising its prudent authority deems it appropriate. In particular, Congress should require cost-benefit analysis for any rule-making by these agencies.

My recommendations generally gibe with the specific framework put forth in the GAO report that any future regulation should have "clearly defined regulatory goals", be "appropriately comprehensive", be "flexible and adaptive" and have a "system-wide focus". [iv] However, I offer a substantive recommendation for implementation of the GAO's framework. I also disagree with the GAO's deliberate failure to put as a primary goal of financial regulation the formation of capital and promoting economic growth. This is the purpose of the financial markets and as such should be facilitated by any regulation. Finally, I note that the many comment letters on the GAO report reveal the wide array of political interests and beliefs at issue in this debate. Some of these interests would prefer the status quo, fractured regulatory system. I address below why that is increasingly unpalatable and not in the nation's best interest.

I would also like to add a caveat to my discussion. This is not a formal academic research paper, but rather is written for a widespread audience of policymakers, regulators and the public generally. Accordingly, while I make policy recommendations and draw conclusions informed by the academic and wider research literature, my own conclusions are simply that – recommendations based on the information currently available and not original research.

**The Root Causes of the Financial Crisis**

The causes of the current financial crisis are still the subject of much study and debate and will remain so long after Congress acts on any financial reform. Nonetheless, at this point eighteen months into the crisis we have a rough sketch.

In summary, historically low interest rates led to excessive borrowing by both individuals and financial institutions. With respect to individuals, a primary focus of borrowing was with respect to real estate, a readily accessible investing asset for most people. The consequence was the rapid rise of housing prices. These prices were increased by demand from so-called "sub-prime" borrowers. During the period from 2005-2006, subprime lending was approximately $1.2 trillion of which $960 billion was securitized.[v] The amount of outstanding subprime mortgage debt grew 801% from 2000 through 2006 to $732 trillion.[vi] These loans were often issued and underwritten under the assumption that "housing prices do not fall".

But when the housing and credit bubble did indeed begin to deflate due to the subsequent rise of interest rates, and housing prices halted their growth and began to fall ever more rapidly, the subprime market, the most vulnerable market, was the first to collapse. Many of these loans entered into default and foreclosure rates began to increase. The high foreclosure rate has had a domino effect across the real estate market pushing prices further lower.

It is now clear that in many instances borrowers were placed into loans they can not now afford. Theoretically, the lender/lendee relationship could have served as a circuit-breaker creating a monitoring function that prevented these inappropriate loans instead focusing on the ability of borrowers to repay. However, the traditional "It's a Wonderful Life" banking model where lenders and borrowers passed each other on the street and lenders personally assessed the creditworthiness of their clients has long past. Mortgages are now securitized into asset-backed facilities called collateralized debt obligations, or CDOs, and sold into the market as mortgage-backed securities or MBSs. Subprime residential mortgages are typically securitized in specialized CDOs called residential MBSs, or RMBSs.[vii] Lenders now serve as intermediaries in this "originate to distribute" model and are more concerned with the ability to sell these loans than for the loans to be repaid.[viii] Many of these lenders, particularly for subprime mortgages, were non-bank lenders subject to differing oversight and regulation than their bank counter-parts.

RMBSs are often voluntarily registered with the SEC in order to offer them to a wider array of investors while other types of CDOs generally are not.[ix] The SEC liberalized the registration process for these securities in 2005 by introducing Form A/B.[x] The form allowed for streamlined disclosure and discarded the obligation of underwriters to perform due diligence on CDOs to confirm adequate loan documentation.[xi] In essence, for those CDOS that were registered, the SEC relied upon private underwriters to uphold standards. Here, the underwriter also procured a private ratings agency to rate the CDO's tranches. Notably though, the SEC was only responsible for ex ante regulating disclosure in the securitization process when the underwriter chose to register the securities and offer them generally to the public. In other cases the SEC's oversight was limited to its antifraud powers. And in no instances was the SEC responsible for the mortgage origination process. In addition, under the Credit Rating Agency Reform Act, the SEC was affirmatively denied the ability to "regulate the substance of credit ratings or the procedures and methodologies by which any [rating agency] determines credit ratings."[xii] In hindsight, the SEC and the other financial regulatory agencies lacked complete oversight over this market; and it was a market that was at best subject to overlapping and conflicting oversight.

It now appears that in the housing boom, the underwriting standards for MBSs generally and RMBSs in particular decreased as the housing boom progressed.[xiii] Moreover, in some instances outright misdirection and fraud directed at consumers by mortgage brokers has been reported.[xiv] And, of course, the ratings agencies were horribly off the mark in assessing the risks of these securities.[xv] The role of individual actors and regulatory agencies in the mortgage crisis is still being fleshed out. Nonetheless, it appears that the direction of fault appears clearer -- it has already been found that the higher the rate of subprime mortgage securitization the higher the rate of default by a measure of approximately 20%.[xvi] The securitization process appears to be at the heart of the mortgage crisis due to the moral hazard and excess risk taking it engendered.

The general decline in the subprime market seeped into the general market in approximately August of 2007. At that time, there was not only a flight from securities containing subprime mortgages and RMBSs, but also a general flight from MBSs due to disbelief about the accuracy of their ratings and the quality of information in the market.[xvii] The result was a crash in pricing in these assets and a flight away from their ownership. At that time, the general credit markets began to freeze and the "merry-go-round" literally stopped. Financial institutions were hit with a triple whammy 1) declining real estate assets and securities on their balance sheet which they could not dispose of and now were priced at distress levels, 2) inordinate leverage from the credit bubble, and 3) a declining economy which reduced their general profitability. Financial institutions who had dealt heavily in real estate-related securities or markets were particularly vulnerable. In addition, many financial institutions had engaged during this time in widespread use of off-balance sheet special purpose vehicles to remove liabilities from their balance sheet. In July 2008 Citigroup alone had $1.1 trillion in off balance sheet special purpose entities.[xviii] In the wake of the financial crisis many of these liabilities were forced by the banks to be assumed placing further stress on their capital adequacy.

During the period from August 2007 through March, 2008, banks rushed to recapitalize from private investors. Nonetheless, the week of March 11, 2008 Bear Stearns collapsed. In hindsight, the investment banking model was one over-susceptible to shocks. Unlike bank holding companies, investment banks historically had a leverage model ranging from 20:1 to 30:1 and as of August 2007, three of the five investment banks, including Bear, had a leverage ratio greater than 30:1.[xix] Meanwhile, for day-to-day capital liquidity investment banks relied on repurchase agreements and prime brokerage reserves. The source for this capital was other investment banks and hedge funds. Either party could rapidly move these reserves in the case of doubt as to the financial institution's viability. In a panic the model would quickly collapse, and that week of March 11 a classic run on the bank occurred with Bear Stearns. Fear and information asymmetry over Bear's viability led to a self-fulfilling loop as Bear's stock price declined and counter-parties moved to withdraw funds in response further hastening Bear's downfall. We all know what happened to Bear, but going into March Bear was rated AAA on some of its secured debt by the ratings agencies and the SEC had felt Bear to be "comfortably" capitalized.[xx]

The fall of Lehman Brothers similarly unfolded and was also due in part to over-reliance on highly movable capital for daily liquidity. However, Lehman's downfall showed the interconnectedness of the financial system. The fall of Lehman led the money market fund Reserve Primary to "break the buck". Reserve Primary broke the dollar floor after writing off $785 million in Lehman Brothers debt. The resulting outflow of money was remarkable; Reserve Primary's assets plunged more than 60 percent to $23 billion in two days.[xxi] Over that week, $170 billion of investor funds flowed out of the money market institutions as investors began to realize that these funds lacked a federal guarantee like ordinary bank deposits.[xxii] The Federal Reserve was forced to step in with a program to insure money market funds. The reason the Federal Reserve did so was due to the role money market funds play as purchasers in the commercial paper market, the primary source of working capital for much of corporate America.[xxiii] If the money market fund industry ceased to function, the commercial paper market would collapse leaving companies who relied upon this financing no choice but to file for bankruptcy. Meanwhile, the fall of Lehman led to a failure of confidence in the investment banking model. This led to Merrill Lynch's acquisitions and the conversion of Morgan Stanley and Goldman Sachs to bank holding companies as they sought more stable forces of funding capital liquidity. Investors lacking information on the pricing of any assets ran for safe assets such as U.S. Treasuries.

At the time, there was a significant outcry that the failing of Lehman and perhaps Bear Stearns was due to shorting of their stock in the market and the crisis in confidence it created. In some cases it has led to cries of regulation of the CDS market and a prohibition on shorting. CDSs notably, were deliberately legislated to be left unregulated by Congress in The Commodity Futures Modernization Act of 2000. The veracity of these claims is unknown at this point. In fact, due to the lack of information about trading in the CDS and private market, I doubt anyone will ever be able to definitively conclude one way or the other whether this was a contributory cause of Bear or Lehman's collapse.[xxiv]

The full role of derivatives generally in the financial crisis still appears uncertain. Clearly in some circumstances derivatives increased risk heightening the impact of the rapid decline of MBSs (to be fair in some cases they served their function and did the opposite hedging risk). The opaque pricing of CDSs may have also led CDSs to be priced too low lulling the market into false security about the state of the housing market. More certainly, AIG was brought down because of underwriting of CDSs out of a London-based subsidiary. [xxv] AIG notably was regulated by the Office of Thrift Supervision as a savings and loan holding company because of AIG's control of a thrift, but AIG was not subject under this regulation to the same scrutiny or requirements of a bank holding company. Furthermore, the interconnectedness of the derivative world led to a great shock when Lehman collapsed and its massive derivatives trades had to be unwound. Nonetheless, as in the particular causes of Lehman's and Bear's downfall, we will likely never know the true impact of derivatives in the financial crisis as again the private derivatives market, particularly the CDS market, is not fully reported.

The Inspector General of the SEC issued on September 25, 2008 a report on the SEC's now defunct voluntary regulation program of the five investment banks, the Consolidated Supervised Entity program. Deprived of regulatory jurisdiction over these key market participants, the SEC readily agreed to a voluntary regulation program when the investment banks proposed it in 2002. The banks did not do so out of saintliness. Rather, they needed a primary regulator under the European Union Financial Conglomerates Directive, and preferred to accede to SEC regulation rather than be regulated directly by the European Union.[xxvi]

The program was doomed to fail and understaffed from the start –three SEC employees were assigned to monitor each bank.[xxvii] Moreover, the investment banks may have complied with their capital requirements and the CSE program generally, but the SEC never conducted appropriate, in depth inspections as to risk measurement, capital liquidity sources and other disclosure.[xxviii] This was true even after Bear fell. The investment banks were able to leverage a regulatory gap to avoid in-depth scrutiny of their leveraging and risk processes.

Initially deprived of statutory ability to fully address the crisis, the government would engage in what Professor David Zaring and I call "regulation by deal" in order to attempt to salvage the financial system. In a series of transactions, the government nationalized Fannie Mae and Freddie Mac, bailed out AIG, and arranged for the sale of Wachovia and the banking deposits of Washington Mutual. Then with the passage of the Emergency Economic Stabilization Act and adoption of the TARP program the Treasury Department agreed to invest $125 billion in the country's nine largest financial institutions. Since that time the government has been administering the TARP program; along the way the bail-out of AIG has been reworked, Citi has received a second set of TARP funds and GM and Chrysler received TARP funds under the automotive component of TARP.[xxix] As I write this, it is being reported that Citi and Bank of America are negotiating yet another round of TARP injections.

Each of these deals has been on different terms and structured seemingly on an ad hoc basis. From news report in the Wall Street Journal and other sources it appears that the coordination of the FDIC, Treasury and Federal Reserve on these individual bail-outs was sometimes strained by disagreement over each of their agencies' role and statutory capacity.

This may have contributed to the ad hoc nature of the government's response.[xxx] The statutory limitations on these agencies, and the lack of an in-place lender of last resort, also affected the regulators' ability to fully respond to the financial crisis. I do not make an assessment of the government's response to the financial panic, but note that the perceived cure to a panic and general credit freeze is to restore confidence in the markets by assuring participants that there is no longer an informational deficit or otherwise by providing a strong, believable market back-stop.[xxxi]

**Regulators and the Financial Crisis**

When surveying the regulatory failures of the past years, it is easy to write off the event as due to a cascading panic brought on by the common misperception that housing prices never fall. And indeed some of the regulatory stress and panic was brought on by extreme events attributable to this now quaint misconception. However, viewing even the brief, preliminary and partial summary of the financial crisis above it is possible to see the regulatory black holes and gaps, as well as regulatory overlaps, that were a factor in the financial crisis. These included a lack of:

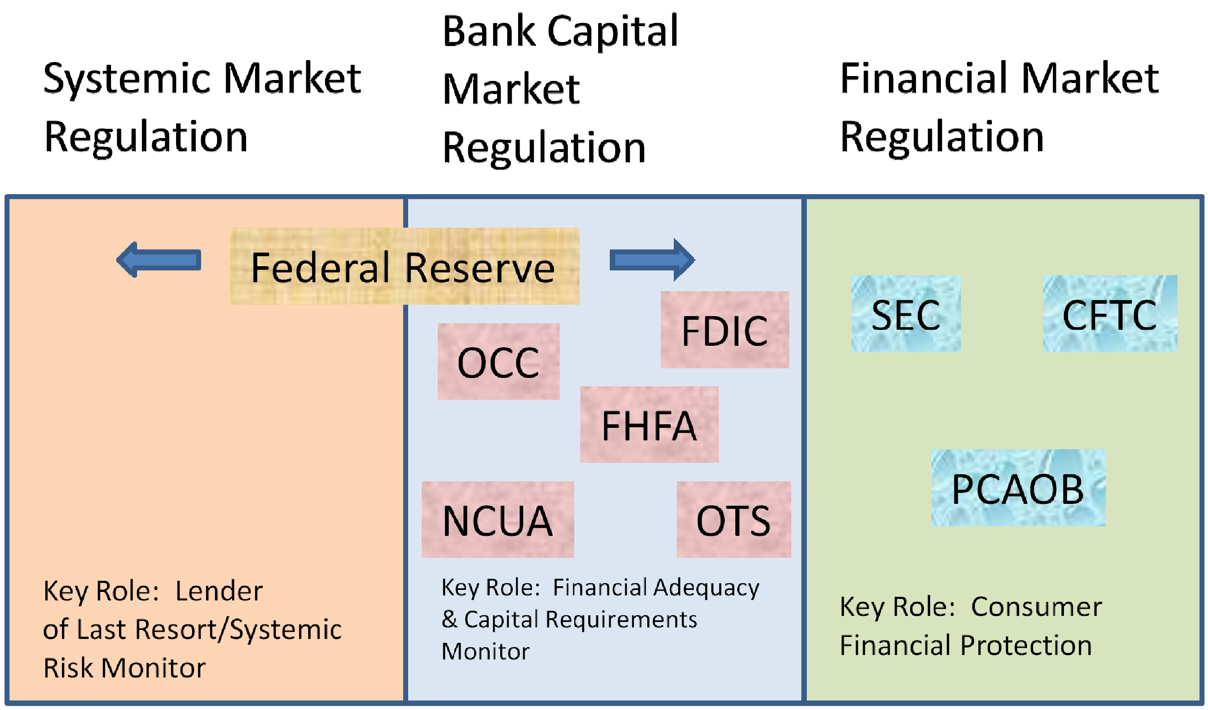
- an effective regulatory authority over the five investment banks, major pillars of our financial markets;
- regulatory authority over the CDS market, a $57 trillion notional value market;[xxxii]
- sufficient regulatory authority over the securities trading and issuing arms of insurance companies;
- sufficient regulatory authority over the ratings agency process;
- a coordinated systemic regulator in times of market panic who can statutorily function as a lender of last resort;
- a singular regulator with direct oversight over the "originate to distribute" mortgage model;
- any regulatory information gathering ability on the trading activities of hedge funds and other market participants outside of the public markets, particularly with respect to CDSs;
- accurate public understanding of the true financial state of financial institutions due to the continued use of off-balance sheet special purpose vehicles;
- an active, comprehensive financial consumer protection regulator to monitor proper disclosure for financial markets, particularly the consumer mortgage and credit markets; and
- coordination between the SEC, Treasury, FDIC, CFTC and Federal Reserve and other regulators over systemic market regulation.

In some cases -- such as trading in CDSs -- these were information deficits which may have informed regulator response. In other cases -- such as the lack of a statutorily empowered systemic regulator -- these directly hampered the government's ability to respond to the financial crisis or perhaps do something earlier. But in large part these deficits arose from the fractured nature of our regulatory system. Here, the arbitrage potential of this system was self-apparent. For example, the five investment banks avoided stricter capital regulation and oversight by avoiding the strictures of the bank holding company act while credit default swaps were able to exist in a financial netherworld avoiding regulation as either a derivative or insurance when their promoters convinced regulators of both products to treat it is the other. [xxxiii]

**The Future Financial Regulatory Structure**

Regulation should not just address the prior crisis, but look forward. We should use the opportunity created by this financial crisis to fix the mistakes of the preceding years but also to regulate to future problems. Here, the most glaring hole in U.S. regulation remains its fractured nature. The GAO report ably details the history and archaic state of today's financial regulatory apparatus. Without knowledge of where the next crisis may come, any financial regulator should have jurisdiction over the entire financial market (both public and private) and over all financial institutions. For these purposes I define financial markets as the sale, purchase and trading of securities. Securities encompasses the trading of all types of derivatives, including insurance type derivatives such as credit default swaps. Regulators should have the ability to create markets for these securities and to require trading reports. Moreover, financial institutions should be broadly defined to include all financial institutions. This includes insurance, hedge funds, private equity, endowment funds, pension funds, and any other actor in our financial market that regularly trades, issue or underwrites securities or insurance.

Much will be said about who should do what in this scheme. Some will favor a single-model regulator like England's FSA, others Australia's and The Netherlands' Twin Peaks model.[xxxiv] But, analytically one should separate out each of these functions into three broad categories:




CFTC=Commodities Futures Trading Commission; FDIC=Federal Deposit Insurance Corporation; FHFA=Federal Housing Finance Agency; Federal Reserve=Federal Reserve System; NCUA=National Credit Union Administration; OCC=Office of the Comptroller of the Currency; OTS=Office of Thrift Supervision; PCAOB=Public Company Accounting Oversight Board; and SEC=Securities and Exchange Commission.

It is self-obvious that the three functions here are overlapped in the current regulatory scheme. The regulatory functions of each of these agencies can be consolidated into one of three overlapping lines. Ideally, Congress would slot each of these into the right regulatory slot creating three regulators. But to the extent it is not politically possible or otherwise feasible, Congress should build regulatory champions. These should be dominant regulators in each field. Any other regulators in each of these fields should be put in a reporting position to the dominant regulator and their powers limited as much as possible. Additionally, the recommendations in this testimony are goals to be fulfilled over time and phased implementation may be the most politically feasible route.[xxxv]

The financial markets regulator would be the heir to the SEC, CFTC and PCAOB. The financial markets regulator should have the capacity to regulate the financial markets and financial institutions from a consumer protection aspect. The financial market supervisor should be given a charge for all financial market consumer protection. This means not only enforcement but education and responsibility for ensuring clear market disclosure. Today there is fractured responsibility for this, and for example, The Truth in Lending Act of 1968 is administered by the Federal Reserve. Regulation of this nature should be concentrated into a financial market regulator who is provided a strong mandate for consumer protection.

The systemic regulator would be a new regulator with power to be a lender of last resort. A systemic regulator should be set up to coordinate between the bank regulator and the financial markets regulator. This is likely the Federal Reserve, the natural choice to have new lender of last resort powers. These powers must be sufficiently broad to act, but also to have some discretionary element, so that the timing of their use is unknown to the markets. This would prevent the moral hazard that comes with certain knowledge of government intervention.

A third regulator should be set up for banking and leverage as heir to the FDIC, FHFA, NCUA, OCC, and OTS. This function could conceivably be within the systemic regulator building a twin peaks model. However, given the special governance arrangements of the Federal Reserve which keep it removed from Congressional oversight and influence in greater measure than a normal independent government agency, I believe this function would be better sited as an independent agency. Here, any institution which takes on leverage and has systemic ramifications should come within the oversight of the panel. In particular, both hedge funds and insurers should come under the aegis of the banking and capital regulator.

In essence this proposal is similar to the recommendations of most other regulatory restructuring plans but is different in calling for a broader possible reach of these regulators to cover the private markets and previously unregulated financial institutions like insurance companies.[xxxvi] Obviously, the powers of these regulators will overlap with state functions particularly in the insurance realm. But the proposal should preserve state regulation and overlay federal to allow for systemic oversight. In particular and again with respect to insurance it may be politically prudent to begin by simply offering a federal charter option for insurance companies and providing special regulation for non-State supervised affiliates of insurance companies who underwrite or trade securities.

Moreover, Congress should at this point focus on setting up sustainable and flexible regulatory structures. The Treasury Blueprint made a case for principles over rules-based regulation.[xxxvii] Congress should leave these issues up to the newly formed agencies; instead setting up broad frameworks and guidelines which allow for cost-benefit analysis and rule-making to fill in the broad financial architecture created. Where appropriate these agencies can return for further authorizing legislation.

This flexibility must take into account the future financial revolution. For example, the phenomenon of securitization of mortgage-based securities is thirty years old. Hedge funds have only reached prominence in the past decade. The capital markets will change and evolve. Regulation must allow for this creative destruction, being flexible not to stifle it but also to regulate it as necessary. The beauty of the Securities Act of 1933 and the Securities Exchange Act of 1934 is that they provided a framework which could be filled in by the regulator. The validity of this approach is witnessed by the continuing operation of these statutes. Congress should follow this pattern erecting a flexible financial apparatus and leaving the rule-writing largely to those agencies. If Congress writes set rules now these will need to be amended in the short future as financial markets change and new products develop. Moreover, Congress risks being unable to accomplish any reform if it gets bogged down in the details of each financial measure.

The assignment of broad categories of oversight function also allows for something that the current system does not: responsibility. The fractured and overlapping jurisdictions of the current regime allows for regulatory lapses to be passed to other agencies or otherwise for no fault to be attributed. A clearly defined role allows for agencies to assume this responsibility and build public confidence while at the same time having a real threat of being viewed as failing when they are so responsible.

Otherwise, the non-political arguments for preserving separate regulators in each of these categories are few. The most prominent is that separate regulators preserve regulatory competition thereby preventing uneconomic regulatory action. This argument was made in certain of the comment letters on the GAO report. For example, the existence of the CFTC provides a counter-part to the SEC by providing competition for regulatory jurisdiction and an alternative model of securities regulation.[xxxviii] Alternatively, in the banking context the American Bankers Association wrote in response to the GAO report that the current system "provides a useful check against any one regulator neglecting its duties, becoming too calcified for an ever-changing marketplace, growing overly bureaucratic and ineffective, or otherwise imposing regulatory conditions inconsistent with the ability of financial firms to serve their customers."[xxxix]

In today's globalized world, though, there are ample models abroad in other jurisdictions. Moreover, the global capital marketplace provides a significant competitor which provides an equivalent regulatory check.[xl] A further check is provided by interest groups and the active and open nature of today's government. In any event, at this point the costs of separate regulators in terms of conflict, lack of jurisdiction and diminished responsibility appear to outweigh any benefits. In particular, the size and scope of the financial market makes it inappropriate to be regulated by types or products –so-called functional regulation established by the Gramm-Leach Bliley Act of 1999 -- but rather the market should be regulated on a holistic basis. As the GAO report notes today's capital markets are too large and interconnected to allow for fractured or functional regulatory oversight. Congress should consolidate the current nine existing regulators into two or three strong, flexible regulators.

**Capacity for Regulation Does Not Equal Regulation**

I want to be very clear here that I am not calling in this hearing for any specific measure of regulation. Rather Congress should empower each of these regulators with the capacity to regulate and have them determine the appropriate level of regulation. This would only be done if, after public debate and the rule-making process, the agency determines that costs of such regulation outweigh its benefits. [xli] As I have said, the beauty of the Exchange Act and Securities Act were that they allowed for similar flexibility. Congress would do well to mirror their successful aspects.

So, for example, a financial market regulator should have newfound oversight powers over all financial institutions, including hedge funds. In this testimony, I do not express an opinion as to whether hedge funds should actually be regulated, but instead that any regulator should be empowered to look at the issue and provided with the ability to impose regulation as part of its general power over all financial institutions. Similarly, a financial regulator should have the power to regulate CDSs requiring that they be traded on a central market or that unhedged positions held in companies must be reported. Again, the actual regulation would come, if at all, from the regulator through the rule-making process. Of course, in certain important areas Congress may want to impose its own rule. However, this should be only in important circumstances and should not devolve into a complete rule-making legislative process.

Furthermore, a bank capital regulator would likely have the powers to regulate capital requirements for not just banks, but all other financial institutions. This would break new ground for imposing capital requirements on hedge funds, for example. But while the bank regulator should have the power to impose such requirements, it may deem such requirements unnecessary or otherwise fulfilled by the market function and regulation of banks themselves. Finally, any systemic regulator will lack overall power if it does not have the power to regulate those financial institutions which can place material systemic risk on the capital market. In particular, again hedge funds should be subject to these rules as well as insurance operations.

**Conclusion**

We live in troubled times. But the financial crisis presents an opportunity to rework the modern financial architecture. Congress should take this unique chance to create a flexible regulatory apparatus which can respond to the unknown perils and change of the future. In particular, Congress should realize that the financial crisis of the past two years has exposed the fractured and archaic U.S. regulatory structure for what it is. Regulatory gaps and black holes should no longer grow and thrive. It is time for the Congress to create comprehensive regulators who can ably assess and economically regulate, if necessary, the entirety of the U.S. financial market. Financial regulators should be provided the tools to meet, and perhaps prevent, the next crisis.

[i] These institutions are the Commodities Futures Trading Commission, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, Federal Reserve System, National Credit Union Administration, Office of the Comptroller of the Currency, Office of Thrift Supervision, Public Company Accounting Oversight Board, and the Securities and Exchange Commission.

[ii] The gross market value of these derivatives was $20.3 trillion. See BIS Quarterly Review, Dec. 2008, available at http://www.bis.org/statistics/derstats.htm.

[iii] See Standard & Poors, Under Fire, Rated Hedge Funds Will Likely Retool And Rise Again, Oct. 27, 2008, available at http://www.thehedgefundjournal.com/research/s-p/under-fire-rated-hedge-funds-will-likely-retool-and-rise-again.pdf. See also Kerry Grace, Hedge Fund Assets Cratered in 2008, The Wall St. J., Jan. 13, 2009.

[iv] See GAO Report, A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System, GAO-09-216 (Jan. 8, 2009).

[v] See Gary Gorton, The Panic of 2007, at 3 (Aug. 4, 2008), available at http://www.kc.frb.org/publicat/sympos/2008/gorton.08.04.08.pdf. See also Atif Mian & Amir Sufi, The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crisis (May 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1072304.

[vi] See Federal Reserve Board, Inside MBS & ABS.

[vii] See Patricia A. McCoy & Elizabeth Renuart, The Legal Infrastructure of Subprime and Nontraditional Mortgage Lending, in Borrowing to Live: Consumer and Mortgage Credit Revisited 110 (Nicolas P. Retsinas & Eric S. Belsky eds., 2008).

[viii] See Basel Committee on Banking Supervision, Bank for International Settlements (2008), The Joint Forum, ―Credit Risk Transfer,‖ Consultative Document (April). See also Gorton, supra note v, at 19-31.

[ix] See Jennifer E. Bethel, et al., Law & Economic Issues in Subprime Litigation, at 15-16 (Mar. 2008).

[x] See Asset Backed Securities, Securities Act Release No. 8518 (Jan. 7, 2005).

[xi] See Richard Mendales, Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown and How to Fix It (2008).

[xii] 15 U.S.C. §78o-7(c)(2).

[xiii] See President's Working Group on Financial Markets, Policy Statement on Financial Market Developments (Mar. 2008).

[xiv] See Patricia A. McCoy, Turning a Blind Eye: Wall Street Finance Of Predatory Lending, 75 Fordham L. Rev. 2093 (2007)

[xv] See John P. Hunt, Credit Rating Agencies and the 'Worldwide Credit Crisis': The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement (Sept. 5, 2008), available at http://ssrn.com/abstract=1267625.

[xvi] See Benjamin J. Keys, et al., Did Securitization Lead to Lax Screening? Evidence from Subprime Loan (Apr. 2008), available at ssrn.com/abstract=1093137.

[xvii] Gorton, supra note v.

[xviii] See Bradley Keoun, Citigroup's $1.1 Trillion of Mysterious Assets Shadows Earnings, Bloomberg.com, Jul. 13, 2008.

[xix] See U.S. Securities and Exchange Commission, Office of the Inspector General, SEC's Oversight of Bear Stearns and Related Entities: The Consolidated Supervised Entity Program, at 120 (Sept. 25, 2008).

[xx] See Securities and Exchange Commission, Chairman Cox Letter to Basel Committee in Support of New Guidance on Liquidity Management (Mar. 20,2008), available at http://sec.gov/news/press/2008/2008-48.htm. See also Steven M. Davidoff & David Zaring, The Big Deal: The Government's Response to the Administrative Crisis (Nov. 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1306342.

[xxi] See Christopher Condon, Reserve Primary Money Fund Falls Below $1 a Share, BLOOMBERG, Sep. 16, 2008, available at http://www.bloomberg.com/apps/news?pid=20601087&sid=aAj1pHOSthQA&refer=home.

[xxii] See Diana B. Henriques, Treasury to Guarantee Money Market Funds, N. Y TIMES, Sept. 19, 2008.

[xxiii] See Department of the Treasury, Treasury Announces Guaranty Program for Money Market funds (Sept. 19, 2008), available at http://www.treasury.gov/press/releases/hp1147.htm.

[xxiv] I also do not offer an opinion on whether saving Lehman would have avoided the panic – certainly the credit markets were frozen at the time and the deleveraging and losses Lehman heralded would have occurred but over a longer period. Nonetheless, the hasty fall of Lehman may have brought its own excess loses and has been estimated to have cost $75 billion. See Jeffrey McCracken, Lehman's Chaotic Bankruptcy Filing Destroyed Billions in Value, The Wall St. J., Dec. 29, 2008.
[xxv] See Monica Langley, et. al., Bad Bets and Cash Crunch Pushed Ailing AIG to Brink, WALL ST. J., Sept. 18, 2008, at A1.
[xxvi] See John C. Coffee & Hillary A. Sale, Redesigning the SEC: Does the Treasury Have a Better Idea (Dec. 2008), available at http://ssrn.com/abstract=1309776.
[xxvii] See SEC Inspector General Report, supra note xix, at 2.
[xxviii] Id. at ix-xi.
[xxix] See Big Deal, supra note xx.
[xxx] See, e.g., Jon Hilsenrath, et al., Paulson, Bernanke Strained for Consensus in Bailout, The Wall. St. J., Nov. 10, 2008.
[xxxi] See Robert F. Bruner and Sean D. Carr, The Panic of 1907: Lessons Learned From the Market's Perfect Storm (2007).
[xxxii] The gross market value of these derivatives was $3.172 trillion. See The BIS Quarterly Review, supra note ii.
[xxxiii] In the case of CDSs the promoters of this product were able to obtain a congressional bar on their regulation while simultaneously benefitting from the rulings of a number of state insurance commissioners that these products were not insurance, leaving them largely unregulated. Notably, under the McCarran-Ferguson Act insurance regulation is left specifically to state regulation.
[xxxiv] See, e.g., Larry Cunningham and David Zaring, Three or Four Models of Financial Regulation (working draft on file with author).
[xxxv] See, e.g., Howell E. Jackson, A Pragmatic Approach to the Phased Consolidation of Financial Regulation in the United States (Nov. 12, 2008), available at http://ssrn.com/abstract=1300431.
[xxxvi] See, e.g., The Department of Treasury, Blueprint for a Modernized Financial Structure (2008).
[xxxvii] Id.
[xxxviii] See, e.g., Roberta Romano, The Political Dynamics of Derivative Securities Regulation, 14 Yale J. Reg. 279 (1997).
[xxxix] GAO Report, supra note iv, at 72 (Letter from Denyette De Pierro to Orice M. Williams on behalf of the American Bankers Association, dated December 19, 2008).
[xl] See Steven M. Davidoff, Regulating Listings in a Global Market, 86 N.C. L. Rev. 89 (2007)
[xli] Cost Benefit analysis has widespread use and proponents as an appropriate economic regulatory tool even in extreme circumstances. See Cass R. Sunstein, Worst-Case Scenarios (2007).